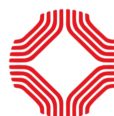
PLDT

ANNUAL REPORT 2004

# AHEAD OF THE CURVE



## COMPANY PROFILE

PLDT is the leading telecommunications service provider in the Philippines. Through its three principal business groups—wireless, fixed line, and information and communications technology—PLDT offers the largest and most diversified range of telecommunications services across the Philippines' most extensive fiber optic backbone and wireless, fixed line and satellite networks.

PLDT is listed on the Philippine Stock Exchange (PSE:TEL) and its American Depositary Shares are listed on the New York Stock Exchange (NYSE:PHI) and the Pacific Exchange. PLDT has one of the largest market capitalizations among Philippine listed companies.

### SUBSIDIARIES

**Wireless**
SMART COMMUNICATIONS, INC. AND SUBSIDIARIES
PILIPINO TELEPHONE CORPORATION AND SUBSIDIARIES
TELESAT, INC.
ACeS PHILIPPINES CELLULAR SATELLITE CORPORATION
MABUHAY SATELLITE CORPORATION

**Fixed Line**
PLDT CLARK TELECOM, INC.
SUBIC TELECOMMUNICATIONS COMPANY, INC.
SMART-NTT MULTIMEDIA, INC.
PLDT GLOBAL CORPORATION AND SUBSIDIARIES
PLDT-MARATEL, INC.
BONIFACIO COMMUNICATIONS CORPORATION

**Information and Communications Technology**
ePLDT, INC. AND SUBSIDIARIES

PLDT ANNUAL REPORT 2004

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THE THEME OF THE PLDT 2004 ANNUAL REPORT IS A BOLD STATEMENT OF OUR DETERMINATION TO STAY WAY AHEAD OF COMPETITION AS WE ANTICIPATE MEETING HEAD ON THE CHALLENGES OF THE FUTURE. THE UNKNOWN THAT LIES BEYOND THE CURVE REPRESENTS NOT ONLY THE FORMIDABLE CHALLENGES BUT ALSO THE RAPID TECHNOLOGICAL DEVELOPMENTS IN THE INDUSTRY AMONG OTHERS, WHICH MAKE FOR AN EXCITING CORPORATE JOURNEY IN THE COMING YEARS.

# AHEAD OF THE CURVE

## PLDT MISSION STATEMENT

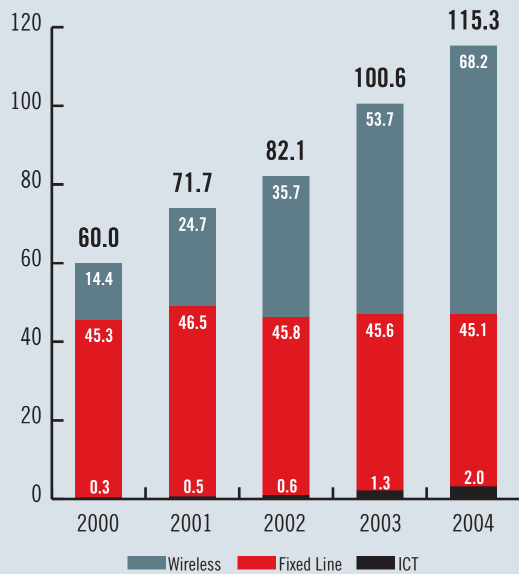
PLDT will be the preferred full service provider of voice, video and data at the most attractive levels of price, service quality, content and coverage, thereby bringing maximum benefit to the company's stakeholders.

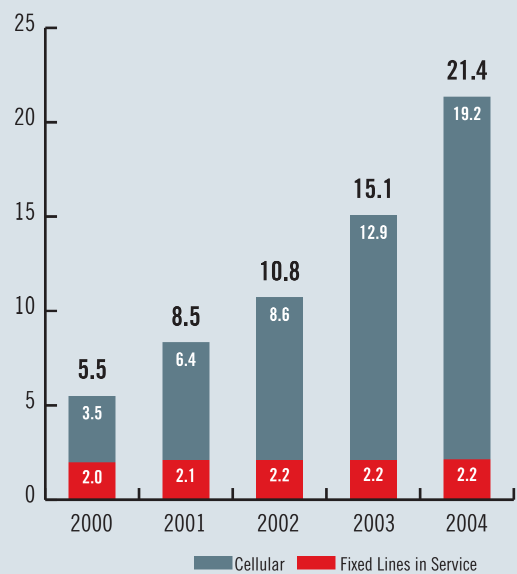
# COMPARATIVE HIGHLIGHTS

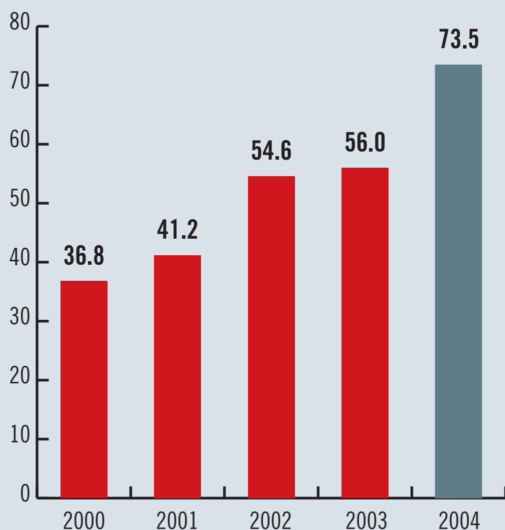
| | 2000[1] | 2001[1] | 2002[1] | 2003[1] | **2004** |
|---|---|---|---|---|---|
| FINANCIAL INFORMATION (in millions, except cash dividends per share of common stock) | | | | | |
| Income | | | | | |
| Service | ₱ 59,956 | ₱ 71,679 | ₱ 82,093 | ₱ 100,604 | **₱ 115,254** |
| Non-service | 3,475 | 9,788 | 12,145 | 10,714 | **6,269** |
| Other income | 520 | 17,726 | 857 | 965 | **4,729** |
| | 63,951 | 99,193 | 95,095 | 112,283 | **126,252** |
| Expenses | | | | | |
| Depreciation and amortization | ₱ 14,423 | ₱ 17,886 | ₱ 22,082 | ₱ 23,606 | **₱ 21,405** |
| Financing costs[2] | 44,432 | 19,838 | 21,766 | 25,386 | **19,420** |
| Compensation and benefits | 9,228 | 9,695 | 11,026 | 14,859 | **12,025** |
| Selling and promotions | 3,242 | 3,046 | 3,647 | 4,399 | **5,708** |
| All others | 22,027 | 39,797 | 52,036 | 42,357 | **34,774** |
| | 93,352 | 90,262 | 110,557 | 110,607 | **93,332** |
| Net Income (Loss) Attributable to Equity Holders | ₱ 20,543 | ₱ 2,788 | ₱ (16,353 ) | ₱ 2,123 | **₱ 28,044** |
| Property, Plant and Equipment | ₱ 269,958 | ₱ 297,128 | ₱ 290,743 | ₱ 306,862 | **₱ 325,076** |
| Accumulated Depreciation, Amortization and Impairment | 60,973 | 70,443 | 87,162 | 112,072 | **130,551** |
| Net | ₱ 208,985 | ₱ 226,685 | ₱ 203,581 | ₱ 194,790 | **₱ 194,525** |
| Capital Expenditures | ₱ 27,109 | ₱ 30,874 | ₱ 16,904 | ₱ 18,019 | **₱ 21,162** |
| Debt[3] | ₱ 198,938 | ₱ 188,494 | ₱ 183,145 | ₱ 178,589 | **₱ 149,088** |
| Equity Attributable to Equity Holders | ₱ 36,872 | ₱ 40,385 | ₱ 23,351 | ₱ 20,678 | **₱ 47,658** |
| Cash Dividends Per Share of Common Stock | ₱ 4.80 | ₱ 1.20 | ₱ — | ₱ — | **₱ —** |
| OPERATING INFORMATION | | | | | |
| Number of Stockholders | 1,730,453 | 1,955,241 | 2,144,953 | 2,207,008 | **2,200,367** |
| Number of Cellular Subscribers | 3,515,293 | 6,368,850 | 8,599,306 | 12,947,197 | **19,208,232** |
| Number of Fixed Lines in Service | 1,999,922 | 2,174,082 | 2,188,612 | 2,185,951 | **2,152,027** |
| Number of Employees | 16,976 | 18,039 | 18,704 | 17,653 | **18,433** |

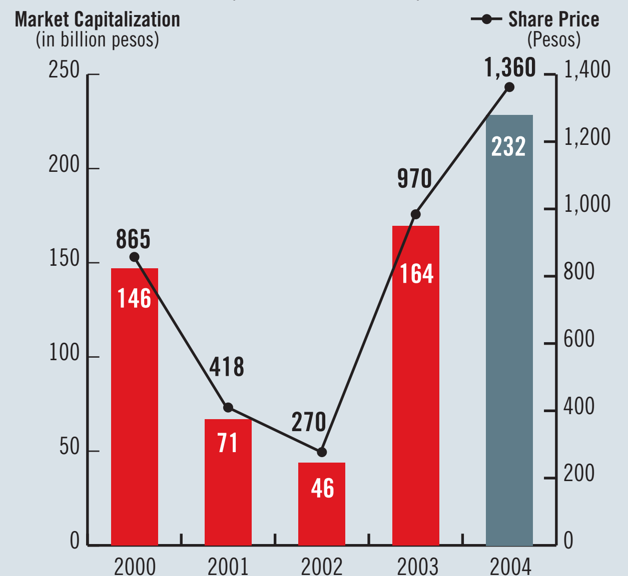
[1] *As restated - see Note 2 - Summary of Significant Accounting Policies to the accompanying consolidated financial statements.*
[2] *Includes net losses on foreign exchange and derivative transactions.*
[3] *Represents short-term and long-term debt.*

# CONSOLIDATED FINANCIAL PERFORMANCE HIGHLIGHTS



# AHEAD OF THE CURVE

## MY FELLOW SHAREHOLDERS,

**I AM PLEASED TO REPORT TO YOU THAT PLDT IS STRONGER TODAY THAN AT ANY TIME IN ITS 76-YEAR HISTORY. WE CLOSED 2004 WITH THE LARGEST PROFIT EVER REPORTED BY A PHILIPPINE CORPORATION. MORE IMPORTANTLY, WE HAVE ENHANCED THE INTERNAL COHESIVENESS OF THE PLDT GROUP AND POSITIONED IT TO TAKE THE LEAD IN INTRODUCING NEXT GENERATION TELECOMMUNICATIONS AND I.T. SERVICES.**

We have thus placed PLDT ahead of the curve and made it far more capable of thriving during this period of disruptive changes in technologies and business models for the telecommunications industry here and abroad.

### A BANNER YEAR

Since late 1998, your management team has sought to rebuild and recast PLDT from a pure landline telephony provider into a diversified telecommunications and technology conglomerate.

That task has been substantially accomplished. PLDT today offers the widest array of communications and IT solutions through the unmatched reach and capabilities of its landline, wireless and Internet-based businesses.

Our 2004 year-end results bear out the soundness of that strategy. Riding on the continued strong growth of our wireless business and the stability of our landline business, profits for 2004 were unprecedented. Consolidated service revenues and net income grew to Php115.3 billion and Php28 billion, respectively, while normalized consolidated net income increased by 237% to Php25.2 billion over 2003's Php7.5 billion restated income.

The surge in revenues and profits, combined with control over cash expenses and over our capital expenditures, boosted our free cash flow, or FCF. This grew to Php37.3 billion for the year, a substantial improvement of 65% over 2003's FCF of Php22.6 billion, which thereby enabled the PLDT Group to accelerate its deleveraging program. By lowering interest charges, deleveraging enhances PLDT's ability to raise cash flow levels and continue delivering robust returns in the years to come.

Our accomplishments last year have paved the way for the resumption of common dividend payments in 2005. Our shareholders have been patient and understanding these past four years. We are, in turn, mindful of our responsibility to bring value back to them. The Php14 per share dividend payment in May 2005, the first such dividend payment to common shareholders since April 2001, is just the initial step. It is fully our intention to raise dividend payments as soon as practicable.

### BRIGHT PROSPECTS

We believe PLDT's prospects in the coming years are promising despite the increasingly intense competition and the transformational changes in technologies and business models now taking place in the domestic and global telecommunications scene.

I have on various occasions called attention to the more modest growth projections for the mobile

industry following several years of strong subscriber base increases. This is taking place just as competition intensifies with the introduction of "bucket" or "flat-rate" pricing schemes.

Meantime, disruptive Internet-based technologies are entering the mainstream and are undermining the business models that have so far built and sustained the fixed line and wireless businesses of telecoms companies throughout the world.

Anticipating these trends, we have primed the PLDT Group for this period of far-reaching changes in four ways.

First, we have strengthened PLDT's financial position to ensure that the Group has the wherewithal to invest in the relevant infrastructure and in the marketing initiatives required by the changing marketplace. As our financial results for 2004 show, we are accomplishing that goal.

Second, the Group has fortified its market position in all key businesses – wireless, fixed line and ICT. It is worth noting that despite energetic efforts by competition, the Group has increased its market share through innovation in products and services, strengthening distribution channels, and cost-effective expenditures and investments.

Third, we have continued to undertake very well-considered preparations to shift our core network from circuit-switch to packet-switch technologies. This process will be accelerated beginning 2005. The move to IP-based systems will enable the Group to offer a wide array of innovative new generation products and services at more reasonable costs.

Fourth, underpinning all these efforts, we have undertaken a comprehensive program to attain higher levels of coordination and cooperation amongst the three major businesses groups – wireless, fixed line and ICT. Since early 2004, we have quietly assembled teams of senior managers, engineers, product development and marketing experts from the different businesses and put them to work to achieve precisely the benefits of an integrated network and a convergent business model.

## THE NEXT WAVE

The result has seen the birth and rebirth of new thinking, new ideas. We are determined on creating and delivering to consumers a host of new services and technologies that fulfill market needs and desires regardless of how these are delivered – on wired or wireless platforms.

This process moved forward without fanfare in 2004. We were largely focused on internal preparations and on putting in place the new technologies, networks and business models needed to support these new services. As a result, we are now firmly positioned for the future.

In 2005, the transformation of the PLDT Group shall become much more manifest as we roll out a new generation of converged services. These services will tap the different networks and systems of the Group in order to better address the specific requirements of various customers. And we are all excited about their prospects.

As next generation technologies come onstream, such services will grow in number and sophistication and provide PLDT's customers unrivaled value. These new technologies will make possible the development of new revenue streams and entirely new businesses that will ensure the continued profitability – and future – of the Group.

Finally, I must express my pride and satisfaction in the fact that PLDT is the first and, thus far, the only Philippine corporation to comply in full with the new International Accounting Standards (IAS) – one year ahead of the required date. This is in line with our efforts to attain higher levels of transparency and accountability in the conduct of our corporate affairs, and align PLDT with the highest and best standards of financial reporting internationally.

In furtherance of this, our Board of Directors approved the Code of Business Conduct and Ethics which define the proper conduct of our business and our officers in matters ranging from competition and fair dealing to disclosure and relations with shareholders and investors.

It is also worth noting that while Philippine law only requires the appointment of a minimum of two independent directors, our Board has exceeded that standard by appointing four independent directors out of the 13.

## CONCLUSION

Let me close by saying to our shareholders that we pledge to continue delivering on our goals with regard our commercial success and financial performance, as well as in our adherence to the highest and best standards of accountability, integrity, fairness and transparency.

In the course of the past couple of years, PLDT has received numerous awards highlighting our increased profitability, our improved management systems and enhanced transparency. Now past the three-quarters' century mark, PLDT is not about to settle down into middle-aged complacency.

I can assure all of you, on behalf of your Board of Directors and the 18,000 employees of the PLDT Group throughout the nation and elsewhere, that we regard ourselves at the start of a new and exciting era. From that perspective, the challenges and rewards of building value for our customers and the country is just beginning.

**Manuel V. Pangilinan**
*Chairman of the Board*

# REDEFINE, REVITALIZE, RENEW

## DEAR SHAREHOLDERS,

**I AM PLEASED TO REPORT THAT 2004 WAS A STELLAR YEAR FOR OUR COMPANY. PLDT POSTED HISTORIC HIGHS ACROSS NEARLY ALL OPERATING METRICS – REVENUES, SUBSCRIBER BASE, FREE CASH FLOW AND NET INCOME. DEBT REDUCTION WAS WELL AHEAD OF TARGETS. IN ADDITION, THE COMPANY'S BOARD OF DIRECTORS FULFILLED A COMMITMENT TO RESTORE DIVIDENDS TO COMMON SHAREHOLDERS BY APPROVING A DIVIDEND OF Php14 PER SHARE.**

### OPERATING GAINS

*Wireless*

Our cellular subsidiaries, Smart and Piltel, sustained their strong performances, contributing considerably to the sizeable rise in PLDT's consolidated net income of Php28 billion. Exclusive of the gain resulting from the debt exchange transaction completed in July 2004, consolidated net income grew to Php25 billion. This figure is more than twice the normalized and restated net income of Php7.5 billion reported in 2003. The 2004 financial results and comparative numbers reflect the impact of adjustments taken as a result of the adoption of all applicable International Accounting Standards (IAS). PLDT has thus accomplished the challenging and complex transition to the new accounting regime seamlessly.

Despite escalating competition, Smart and Piltel, together, added more than 6.2 million subscribers in 2004. This brought the PLDT Group's total cellular subscribers to 19.2 million and maintained our market share at about 58%. Smart added over 4.5 million subscribers while *Talk 'N Text* added another 1.7 million to end 2004 with 14.6 million and 4.6 million subscribers, respectively. In the fourth quarter alone, when a number of aggressive initiatives were launched by competition, Smart and Piltel added over 1.7 million subscribers. The cellular penetration rate continues to exceed expectations, reaching approximately 39% at the end of 2004. It should be noted though that the practice of some subscribers owning multiple SIMs has probably inflated this rate to a certain extent.

More importantly, Smart and Piltel have preserved their share of industry revenues at approximately 59%. Consolidated cellular revenues and net income continued to rise. Consolidated cellular service revenues increased to Php67 billion, 27% higher than the Php53 billion realized last year.Consolidated cellular EBITDA grew by 31% to Php42.5 billion from Php32.4 billion and our EBITDA margin correspondingly improved to 63% in 2004 from 61% the previous year. Normalized net income in 2004 nearly doubled to Php23.3 billion from Php12 billion in 2003 while free cash flow increased by 40% to Php17.6 billion.

In December 2004, Smart paid an additional cash dividend of Php4.8 billion to PLDT, bringing its 2004 total dividend payments to Php16.1 billion. Smart intends to raise its dividend payments to PLDT in 2005 to Php20 billion.

Smart continues to lead as well in terms of network coverage. Its cellular network consisting of 36 mobile

switches and over 5,300 base stations makes our cellular service available to more than 97% of the country's population.

In 2004, Smart also acquired Meridian Telekoms, Inc., a company primarily engaged in providing wireless broadband and data services to small and medium-scale enterprises. This acquisition will strengthen our position in the wireless data segment and is in line with our overall strategy of providing the widest range of innovative wireless services.

*Fixed Line*

The fixed line business remains focused on maintaining the stability of its revenues and containing its cash operating expenses while minimizing capital expenditures. Total service revenues increased by 3%, from almost Php47 billion in 2003 to Php48.5 billion in 2004. This was mainly due to the positive impact of favorable rate and interconnection charges on NLD revenues and higher data service revenues. DSL subscribers numbered almost 50,000 at the end of 2004 from less than 25,000 a year ago and a number of complementary product offerings are in the pipeline.

Cash operating expenses were down 12% due to a higher level of compensation expenses in 2003 resulting from the manpower rightsizing program. Fixed line EBITDA improved by 19%, from Php22 billion in 2003 to Php26.3 billion in 2004. The EBITDA margin likewise increased to 54% this year from 47% last year.

As of the end of 2004, PLDT Fixed Line had 9,692 employees compared with 10,518 employees as of last year, reducing headcount by 826 during the year in line with its objective to right-size its organization.

*ICT*

ePLDT, the Group's information and communications technology arm, reported a net loss of Php693 million for 2004 mainly as a result of a write-down on one of its investments. Without the write-down, ePLDT would have broken even, as the 42% increase in service revenues was offset by a 36% increase in cash operating expenses.

The call center business continues to flourish, with Vocativ and Parlance increasing their seats by 5% and 69%, respectively. The call centers generated revenues of Php1.2 billion, or 58% of our total ICT service revenues. ePLDT call centers' capacity was approximately 2,600 seats at the end of 2004 and is expected to grow by another 775 seats by mid-2005. The Internet and gaming business increased its revenue contribution to Php569 million or 27%, while *Vitro*™ data center contributed service revenues of Php243 million, an increase of 103% over last year's revenues.

## DEBT REDUCTION

The increase in consolidated free cash flow, which grew 65% from Php23 billion in 2003 to Php37 billion in 2004, enabled the Group to accelerate its deleveraging program. PLDT Fixed Line reduced its debt by US$500 million in 2004, surpassing its initial target of US$300 million set at the beginning of 2004 and subsequently raised to US$350 million later in the year. As of the end of 2004, PLDT Fixed Line's debt balance stood at US$1.97 billion. PLDT Fixed Line expects to continue its aggressive deleveraging in 2005, thereby achieving savings in interest and financing costs and, at the same time, reducing its risk profile.

## CORPORATE REORGANIZATION

In 2004, the PLDT Group completed the rationalization of its wireless business with:

- The completion by Smart of the conversion of its Piltel Series K preferred shares into common shares which raised its ownership in Piltel to 85.6%;
- The acquisition by Smart of the remaining 6.5% common shareholding of PLDT in Piltel, subsequently bringing Smart's total ownership to 92.1%; and
- The execution of a new omnibus agreement between Smart and Piltel which superseded and replaced previous management agreements. The omnibus agreement covers the provision of all the services under the previous agreements, in consideration of a revenue sharing arrangement for *Talk 'N Text* service of 80-20, in favor of Piltel. This ratio allows Smart to largely recover its costs while providing Smart and Piltel with a more equitable revenue sharing agreement in the context of the latter's increased subscriber base and the resulting economies of scale. The new arrangement also takes into account declining network and operating costs per subscriber derived from improvements in productivity and technology as well as the tax loss position at Piltel.

## RESTORATION OF DIVIDENDS

On March 1, 2005, the Board of Directors also approved the payment of dividends to common shareholders at the rate of Php14 per share. Payment is scheduled to be made on May 12, 2005, to shareholders of record as of March 31, 2005. This marks the resumption of dividend payments to common shareholders since April 2001 when the last dividend was paid.

## DIRECTION FOR 2005

With 2005 looking to be another challenging and highly competitive year, the PLDT Group has set for itself the following objectives:

- Continue the deleveraging thrust and increase dividends to common shareholders;
- Reduce consolidated debt by US$500 million;
- Achieve a consolidated debt-to-EBITDA ratio below 1.5 times by 2006;

**MY ASSUMPTION IN EARLY 2004 OF THE PRESIDENCY AT PLDT WHILE CONCURRENTLY RETAINING THE SAME POSITION AT SMART SIGNALED THE BEGINNING OF A NEW MINDSET – ONE WHERE WE THINK "GROUP" FIRST. BY "GROUP" WE MEAN HARNESSING THE STRENGTHS OF THE INDIVIDUAL BUSINESSES AND TRANSFORMING THEM INTO TANGIBLE SYNERGIES – BUNDLED PRODUCTS AND SERVICES, INNOVATIVE SOLUTIONS TO MARKET DEMANDS AND AN OPEN ATTITUDE TO THE SO-CALLED "DISRUPTIVE TECHNOLOGIES."**

- Increase common dividend payout ratio in 2006 to a minimum 15% of 2005 EPS;
- Maintain market leadership by introducing more product and service innovations;
- Commence the upgrade to an IP-based network and boost broadband capabilities; and
- Develop bundled products and services across the PLDT Group's various businesses.

## REDEFINE, REVITALIZE, RENEW

Beyond these specific objectives, we need to look at how we can redefine our businesses. The telecommunications industry is a very dynamic one and the markets we serve demand that we keep up with technology to deliver innovative and cost-effective products and services. Our leading positions in the fixed line, wireless and ICT segments coupled with the strength and breadth of our network infrastructure put us in an enviable position to deliver an even broader range of products and services to our customers.

My assumption in early 2004 of the presidency at PLDT while concurrently retaining the same position at Smart signaled the beginning of a new mindset – one where we think "Group" first. By "Group" we mean harnessing the strengths of the individual businesses and transforming them into tangible synergies – bundled products and services, innovative solutions to market demands and an open attitude to the so-called "disruptive technologies." Already we are looking beyond mobile growth and are now focusing on developing new products and services that capitalize on the Group's collective assets and capabilities.

By the time you read this annual report, we would have already launched a number of new initiatives in the tradition of *Smart Load* and *Smart Padala*. *WeROAM*, developed by PLDT's corporate business group but powered by Smart's GPRS/EDGE and wireless broadband networks, is a bundled service that provides mobile workers and remote offices with wireless high speed data connectivity. We have also forayed into the fixed rate voice market with such promotions as *Telebabad* in the fixed line and *Smart 258* in the mobile markets. In the meantime, *Smart Padala*, the first international and domestic cash remittance service via text, which Smart launched in August 2004, now services 14 countries, including the United Kingdom, the United States, Spain, Germany, Canada, Israel, Taiwan, Singapore, Greece, Hong Kong, Japan, Australia and Brunei. This breakthrough service allows overseas Filipino workers to remit their money to their relatives in a more efficient and economical manner.

You know the saying "if it ain't broke, don't fix it." Well, at PLDT we say, "If it ain't broke, make it better!" And that is our promise to you, our shareholders – we will always strive to "make it better," to redefine our businesses continually, to revitalize what is stale, to renew what is dated and always in a manner that is innovative and that builds value for all of our stakeholders.

Sincerely yours,

**NAPOLEON L. NAZARENO**
*President and CEO*

THE TRANSFORMATION OF THE PLDT GROUP INTO A FUNCTIONALLY INTEGRATED COMMUNICATIONS BUSINESS HAS BEGUN.

MANUEL V. PANGILINAN

OUR MANDATE, THEREFORE, AS THE INDUSTRY LEADER, IS TO BE RESPONSIVE TO THESE EVOLVING CONDITIONS AND FIND WAYS TO ACTIVELY DEVELOP NEW MARKET SEGMENTS WHILST CONTROLLING COSTS.

NAPOLEON L. NAZARENO

# It's a data-driven world

## PLDT GROUP POSITIONED FOR NEW GENERATION SERVICES

THE PHILIPPINE TELECOMMUNICATIONS INDUSTRY IS AT THE THRESHOLD OF A NEW ERA THAT PRESENTS BOTH SERIOUS CHALLENGES AND TANTALIZING OPPORTUNITIES. OLD TECHNOLOGIES AND BUSINESS MODELS ARE BEING SUPPLANTED BY NEW, DIGITALLY-POWERED ONES THAT OFFER GREATER VALUE TO CUSTOMERS AND NEW REVENUE STREAMS FOR OPERATORS.

THE ARTICLES THAT FOLLOW PROVIDE A LOOK AT THE EMERGING TELECOMMUNICATIONS LANDSCAPE. THEY FOCUS ON THE GROWING IMPORTANCE OF DATA SERVICES AND THE NEW BUSINESSES – M-COMMERCE, CALL CENTERS AND INTERNET CAFÉS – THAT HAVE COME TO THE FORE WITHIN THE PLDT GROUP.

# DATA-DRIVEN COMMUNICATIONS HAVE BECOME AN INTEGRAL PART OF LIFE FOR MILLIONS OF FILIPINOS. THE PLDT GROUP IS UNIQUELY POSITIONED TO INTRODUCE A NEW GENERATION OF DATA SERVICES THAT WILL HELP ACCELERATE THE COUNTRY'S ECONOMIC AND SOCIAL DEVELOPMENT.

After a four-year courtship, Jane Catherine, a resident of Sta. Mesa, Manila, married her boyfriend, Glenn, in 2004. Just a week after their wedding, her husband flew off to Hong Kong, seeking higher paying jobs. For several months, Glenn sent money to his young entrepreneur-wife through a friend's bank account. Then late last year, he started taking a different route.

Every month, Glenn would go to a Hong Kong remittance company that transmitted his money via text messaging directly to Jane's Smart cell phone using a mobile commerce service called *Smart Padala*. Now, it just takes seconds for Jane to receive the funds.

The popularity of M-commerce services like *Smart Padala* drives home a giant fact that is often overlooked: data-driven telecommunications services have already become an integral part of life for millions of Filipinos.

Moreover, the PLDT Group is uniquely positioned to push forward the development of data services with a new generation of products and services that will help accelerate the country's economic and social development.

## CORPORATE DATA SOLUTIONS

The significant growth of data services has gone largely unnoticed because these have assumed unexpected forms.

The phrase "data services" is usually understood to refer to various corporate data solutions that range from leased lines to virtual private networks, or VPNs. PLDT has extended its data service product offering to include *PLDT myDSL*, which is now increasingly being used by both households and small businesses. By that measure, PLDT's data services have been growing at a healthy rate.

Data revenues for PLDT's fixed line business, for example, have increased by nearly 19%, from Php6 billion in 2003 to Php7.1 billion in 2004. This revenue source accounted for 15% of 2004 fixed line revenues compared to 13% in 2003.

Corporate data services have grown not only in revenues but also in sophistication. Last year, for example, PLDT's corporate business group introduced two new services in 2004. These were *IP Plus* and *PLDT On-Call.*

*IP Plus* is an affordable and flexible suite of three IP network solutions. One solution is called *Internet Protocol Security*, or *IPSec,* for anytime, anywhere and highly secure connectivity through the Internet or any public infrastructure. The second is *Internet Protocol – Virtual Private Network Quality of Service,* or *IP VPN QoS*, which gives corporate clients the ability to prioritize network traffic depending on the type of application in use. The third is *Voice over Virtual Private*

*Network* or *VoVPN* for secure, reliable and cost-effective voice communications between company branches nationwide.

*PLDT On-Call* is the country's first comprehensive solution for clients in the call center industry. It helps companies set up call center operations rapidly and in a cost-effective way.

## THE WIDE WORLD OF MOBILE DATA

But the full contribution of data to PLDT's total business becomes apparent when the discussion goes beyond VPNs to mobile phones in the hands of close to 20 million Smart and *Talk 'N Text* subscribers.

In 2004, data revenues of Smart and Piltel's mobile phone services rose by 44% to Php32 billion and accounted for about half of total cellular revenues. When mobile data revenues are combined with fixed line data revenues and ICT service revenues, the total share of data adds up to Php40 billion, or 35 % of the total.

It seems incongruous at first to lump together corporate solutions with "mobile data" which consists largely of text messaging. This includes apparently frivolous activities like text quiz games, the fervent exchange of love notes between teenagers and the chatter of jokes and gossip that fly thick and fast between friends.

But for Smart, text messaging has become a robust and flexible platform for an impressive array of services. This includes three world-first and multi-awarded mobile payments services – *Smart Money*, *Smart Load* and *Smart Padala* – all developed on top of the m-commerce platform launched way back in December 2000.

Mobile phones can also be used to locate people and places. Location services available through *Smart Kid* mobile phones, for example, enable concerned parents to keep track of their children in school and elsewhere.

Web-based text messaging services such as *NetCast* and *SMS Care* (of Smart subsidiaries WolfPac and i-CON, respectively) enable employees to query their company data base for personnel information like sick and vacation leaves. Students in several colleges and universities can also use such services to check their grades or enroll for the next semester.

The simple fact that each Smart and *Talk 'N Text* GSM handset is a capable mobile data device vastly expands the world of data in the country.

## MORE MUSCULAR PLATFORMS

The data world is expanding in leaps and bounds as more powerful wireless platforms come on stream. Already, some wireless applications are taking advantage of Smart's widely available General Packet Radio Service or GPRS. Using *Blackberry* handsets, for example, officers of the Bureau of Internal Revenue can now quickly query the agency's database while conducting tax checks in the field.

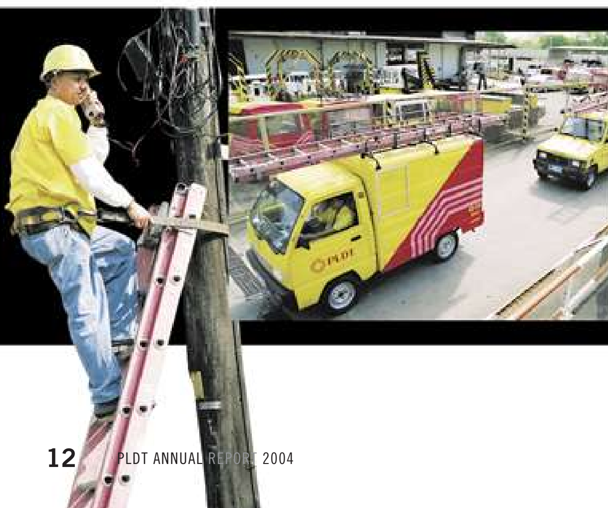
After laying the groundwork in 2004, PLDT launched a new corporate service in early 2005 called *PLDT WeROAM*. The new service has two variants. The first uses Smart's GPRS/EDGE network to provide mobile Internet access to office "road warriors" with speeds of up to 170 kbps. The second variant offers a fixed wireless Internet service with even higher speeds of up to 1 MB using Smart subsidiary Meridian Telekom, Inc.'s, or Meridian's, wireless broadband service.

Smart's acquisition of Meridian has added wireless broadband to the PLDT Group's portfolio of access networks. Meridian offers a proven fixed wireless solution using centrally-located Meridian access node sites, each with a 3- to 15-km radius of coverage. Being wireless, Meridian's broadband solution enjoys clear advantages in terms of quick and cost-effective deployment. It opens up excellent opportunities for making high-speed Internet access much more widely available nationwide.

## EXTENSIVE INFRASTRUCTURE

Continuing investments in both fixed line and wireless network infrastructures has helped position PLDT to take the lead in offering the next wave of services in the country.

We continue to expand our Domestic Fiber Optic Network, or DFON, which is already the most extensive and capacity-rich transmission backbone in the



Continuing investments in both fixed line and wireless network infrastructures has helped position PLDT to take the lead in offering the next wave of services in the country. And, for Smart, SMS has become a robust and flexible platform for an impressive array of services.

Your call has been answered.

Putting up a business has never been this easy!

PLDT BUSINESS SOLUTIONS

Innovating Technology. Initiating Trends. Inspiring Trust.

## FIXED LINE

**"Data services," usually understood to refer to various corporate data solutions ranging from leased lines to virtual private networks, now also includes the growing use of *PLDT myDSL* by households and small businesses.**

**The PLDT Group is uniquely positioned to push forward the development of data services with a new generation of products and services that will help accelerate the country's economic and social development.**

## THE MOVE TO IP BY BOTH FIXED LINE AND WIRELESS NETWORKS MARKS A FUNDAMENTAL TRANSFORMATION IN TECHNOLOGIES AND BUSINESS MODELS AND HERALDS A NEW ERA IN THE TELECOMMUNICATIONS INDUSTRY.

country. Currently, DFON stretches from San Fernando, La Union, in the north down to Davao City in the south. The cable system consists of over 2,700 km of inland cable and 2,408 km of submarine cable. The bandwidth available in DFON is based on a 10G capacity per wavelength or approximately 121,000 simultaneous calls of voice traffic in a single fiber pair. Presently, an on-going expansion program will add another 10G capacity for the network.

PLDT's DFON provides the capacity to haul data-rich traffic to and from different parts of the country. Capacity is the key to meeting the bandwidth-gobbling requirements of businesses and individual consumers.

Based in Baguio City, Texas Instruments Philippines, for example, requires high-speed and resilient data networks securely linked to the world through both international and domestic leased lines. To meet its needs, PLDT has provided large bandwidth leased lines like DS-3, domestic leased lines, direct inward or outward dialing (DID/DOD) on E1 FEX lines, ISDN/PRI and mobile and fixed cellular services.

"PLDT has taken the lead in investing in areas like Baguio which are far from traditional growth areas. PLDT's flexibility, cost and quality of service complement our agility to respond to our markets," said Bobot delos Trinos, IT Director of Texas Instruments.

The Philippine American Life and General Insurance Company, or Philamlife, on the other hand, requires extensive data networks within the country. To serve over a million policy holders, it maintains over 200 offices throughout the country and has over 8,000 sales agents and 1,000 employees.

"If we can quickly issue life insurance policies using advanced voice and data communications, this will give us a competitive advantage," said Philamlife President Jose Cuisia, Jr.

PLDT provides high-speed data communications links connecting Philamlife's head offices to branches in key cities like Cebu and Davao. It also supports the telecommunications requirements of its business process outsourcing operations that include a 100-seat call center.

### FIXED LINE AND WIRELESS ACCESS NETWORKS

Linked to the DFON are PLDT's fixed line and wireless access networks, which are also the most extensive of their kind in the country. Its fixed line network serves over 2.2 million subscribers nationwide. *PLDT myDSL* is currently available in over 140 cities and towns, including all the major urban centers nationwide. It is now serving approximately 50,000 DSL customers and expects to raise this figure to over 80,000 in 2005.

Smart operates the country's most extensive digital cellular network with 36 mobile and transit switches and over 5,300 base stations nationwide. Over 90% of these base stations are GPRS-equipped. The high-speed data packet service called Enhanced Data for GSM Evolution, or EDGE, is now available in all of the country's major urban centers and is being rapidly rolled out in other parts of the country.

Through the same base station network, Smart is currently deploying wireless broadband nodes nationwide. This offers the tantalizing prospect of attaining

### WIRELESS

**The popularity of M-commerce services like *Smart Padala* drives home the fact that data-driven telecommunications services have already become an integral part of life for millions of Filipinos.**

Smart operates the country's most extensive digital cellular network with 36 mobile and transit switches and over 5,300 base stations nationwide.

widespread Internet wireless access throughout the country.

While PLDT has broadened and strengthened its access networks, it has also begun transforming its core network by gradually shifting to Internet Protocol, or IP, systems. Over time, PLDT's existing packet-switched network – which runs on asynchronous transfer mode, or ATM – will be redeployed to the fringes of PLDT's Brains network as the IP core takes over. Meantime, Smart's cellular network is also shifting to IP as it deploys IP Multimedia Service, or IMS, facilities.

The move to IP by both fixed line and wireless networks marks a fundamental transformation in technologies and business models and heralds a new era in the telecommunications industry. This makes possible the introduction of a new generation of services. Fixed line and wireless, voice, video and data will be converged. Such new, more powerful, more affordable services are basic requirements for the Philippines to be competitive in a world where information-rich and knowledge-intensive industries are ascendant.

PLDT has prepared for this transition not only by continuously investing in new technologies. It has also succeeded in developing innovative data services that not only empower corporations but also touch the lives of ordinary Filipinos like Jane and Glenn. By doing so, the PLDT Group today is already positioned for the unfolding data-driven future.

## ICT

**The call center is a booming industry, one of the most progressive in today's economy.**

# Dial 'M' for Money

## MAKING MOBILE COMMERCE WORK FOR THE MILLIONS

Bgy. Batasan Island is a narrow strip of land about a kilometer long, 15 minutes off the coast of the municipality of Tubigon in Bohol. There are around a thousand people in this fishing community which, despite its remoteness, is relatively prosperous – as evidenced by the number of concrete houses and the popularity of cell phones. There are, in fact, five *sari-sari* stores selling *Smart Load*.

It is indeed difficult to find a *barangay* in the country where *Smart Load* is not sold. There are currently about 700,000 retailers selling this innovative product and they are dispersed all over the country, in virtually every nook and cranny of the archipelago.

The tale of remote fishing villages like Bgy. Batasan Island highlights how innovative mobile commerce applications have become so pervasive in the country. Millions of people are getting a hands-on education on mobile commerce, or m-commerce, thus paving the way for more sophisticated applications in the future.

The most widely used m-commerce service in the country is *Smart Load*. Launched in 2003, *Smart Load* is the revolutionary over-the-air prepaid reloading service that dispenses via text message cell phone airtime in sachet-size packages as low as Php30. Its sister service, *Pasa Load*, enables a prepaid phone user to transfer small doses of airtime from his mobile to another's.

There are over three million *Smart Load* transactions plus another three million *Pasa Load* transactions daily.

When *Smart Load* was launched, it was sold through roughly 50,000 stores and agents. By end-2004, over 700,000 retailers were selling *Smart Load* using their mobile phones. About 90% of these retailers are micro-entrepreneurs – *sari-sari* or mom-and-pop stores, housewives, office employees and students.

Electronic loading has changed the buying habits of cell phone users. Instead of buying top-up cards, about 97% of *Smart Buddy* and 93% of *Talk 'N Text* subscribers now use *Smart Load*. In 2004, over 71% of Smart's airtime sales were done electronically.

M-commerce service started in December 2000 with the introduction of *Smart Mobile Banking* and *Smart Money*. A world-first, *Smart Money* is a MasterCard Electronic cash card linked to a mobile phone. Like other cash cards, it could be used as a payment tool. But unlike other cash cards, *Smart Money* has innovative features controlled via a Smart cell phone. For example, the mobile phone subscriber can transfer electronic cash in and out of his *Smart Money* card by simply clicking on a special built-in menu in the SIM of every subscriber, enabling transactions to be done instantly.

The ability to transfer values through text messaging provided the basis for *Smart Load* and *Pasa Load*. The very same feature has also been applied to money remittances. In August 2004, Smart launched the world's first international cash remittance service using text messaging. Called *Smart Padala*, the new service offers over eight million

## PERVASIVE M-COMMERCE APPLICATIONS LIKE SMART LOAD ARE PROVIDING MILLIONS A HANDS-ON EDUCATION IN ELECTRONIC TRANSACTIONS AND PAVING THE WAY FOR MORE SOPHISTICATED APPLICATIONS.

overseas Filipinos an alternative, more affordable and more convenient means of sending money back home to their families.

Marichiel, a young student in Makati City, used to receive money via door-to-door delivery service from her sister, a nurse working in Ireland. On the average, it took three days for the cash to reach her.

When *Smart Padala* was launched, nurses in Europe started to use the service. Marichiel's sister went to a remittance company (Remco) that had partnered with Smart and handed over the cash she wanted to remit. The Remco then used a Smart cell phone to transfer via text message the cash value to the *Smart Money* electronic wallet linked to Marichiel's Smart cell phone. This just took a few seconds.

Marichiel then went to the Smart Wireless Center in Megamall and exchanged her electronic cash for physical cash amounting to about Php40,000. Later on, Marichiel began encashing her remittances at the McDonald's branch near her house. She was the very first customer to encash *Smart Padala* at that fastfood outlet.

"Our family now always use *Smart Padala* as a means to remit and receive money," says Marichiel.

Through life-changing innovations like these, Smart has created an environment wherein large numbers of people are equipped with the tools to do business electronically, opening up endless possibilities for electronic cash transactions in the future.

It is difficult to find a *barangay* in the country where *Smart Load* is not sold.

# Everyone's Internet Café

## NETOPIA BREAKS BARRIERS AND OFFERS BROADBAND INTERNET FOR THE MASS MARKET

In the old days, applying for a job was a real pain. It meant checking out the classified ads, preparing perfectly-typed resumés, and walking from office to office in the sweltering heat wearing a necktie, a long-sleeved polo and leather shoes.

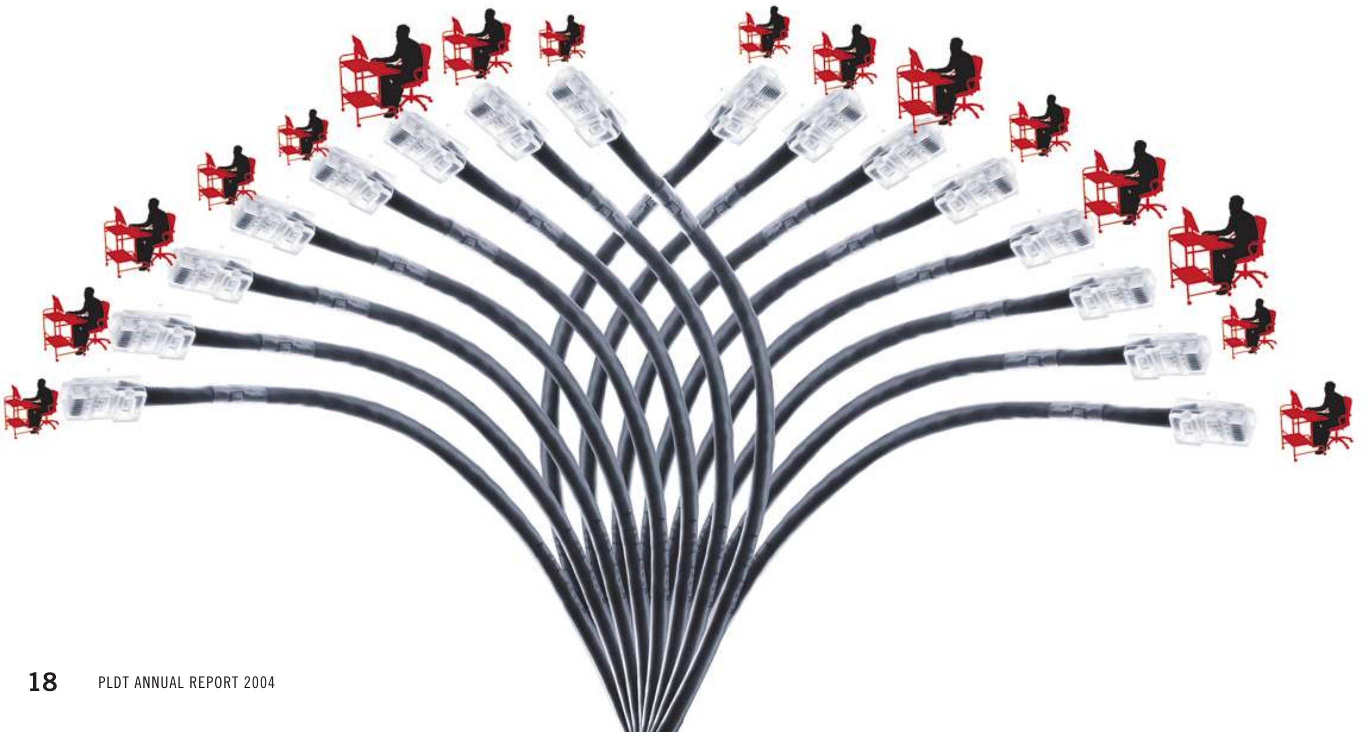
These days, job applicants saunter over to the nearest *Netopia* branch in their jeans and t-shirts. In air-conditioned comfort, they log on to job search Web sites and send multiple copies of the same resumé through e-mail. In an hour, they're done.

This is just one example of how life is being changed by the increased availability of Internet access. And because personal computer, or PC, penetration in the Philippines remains low, the way forward is being led by Internet cafés that have mushroomed all over the archipelago.

The largest of the lot is *Netopia*, the Internet café chain owned by Digital Paradise, Inc., a subsidiary of ePLDT. With over 150 branches (including three in Bangkok, Thailand), *Netopia* has set the pace for this fast-growing business by offering affordable, high-speed broadband Internet access.

"We develop and manage shared access facilities for the mass market. We make it possible for ordinary Filipinos to experience and benefit from broadband Internet," says Raymond Ricafort, President of Digital Paradise, Inc., the owner, operator and franchisor of the *Netopia* Internet café chains.

*Netopia* promotes mainly Internet usage and other computer-related value-added services. As of end-2004, Internet-related



revenues accounted for over 50% of *Netopia*'s revenues.

Aside from web browsing, chat and e-mail, *Netopia* customers can use its web cam service to see and talk with their relatives and friends in other provinces or even overseas. They can also avail of printing services and "burn" CDs as well. Internet and network games are very popular, especially among teenagers.

For years, the growth of Internet usage has been hobbled by the sheer lack of personal computers in the country. Researchers estimate that there are only 20 PCs per one thousand persons in the Philippines. This is way below the rate in other countries. In Singapore, for example, there are 510 PCs per thousand.

Internet cafés like *Netopia* have made it possible to overcome this obstacle. In recent years, Internet usage has risen visibly despite the low rate of computer ownership. With over 6,000 workstations, *Netopia* alone serves over two million people a month.

To make high-speed Internet even more accessible to the public, *Netopia* is taking the next step forward: it is developing Mobile Internet Cafés, or MICs.

MICs are converted 40-foot container vans equipped with 16 desktop computers. These computers are linked to the Internet using either DSL or wireless broadband facilities.

Being mobile, MICs can be easily transferred from one location to another, depending upon the need. These can be parked permanently in one site – for example, a school or a community. They can also be used to test and develop the market in a specific location, prior to the establishment of a permanent site. As of 2004, *Netopia* had three fully-operational MICs.

*Netopia*'s fast growth has also been powered by its success in tapping enterprising individuals,

**To make high speed Internet even more accessible to the public, *Netopia* is taking the next step forward: it is developing Mobile Internet Cafés.**

## FOR YEARS, THE GROWTH OF INTERNET USAGE HAS BEEN HOBBLED BY THE SHEER LACK OF PERSONAL COMPUTERS. INTERNET CAFÉS HAVE MADE IT POSSIBLE TO BYPASS THIS OBSTACLE.

mostly young professionals, as franchisees.

Carlo is one such valued business partner. He is part of a group of seven individuals who have invested in and are currently operating a *Netopia* branch in a well-known mall.

"We got into this business because we see the expanding, everyday use of the Internet, and a huge market of people who do not yet have access to reliable, high-speed Internet," he says. "We could have done this on our own, but *Netopia* provides both a great system for managing the business and a strong brand with its over 100 outlets nationwide."

Ranging from 40 to 130 work stations, each *Netopia* branch is supported by the established *Netopia* process. Strong brand recognition helps bring business to each branch. This is further reinforced by the uniform high quality of service offered throughout the chain of stores. Membership in one *Netopia* branch entitles you to the same discount privileges in all branches.

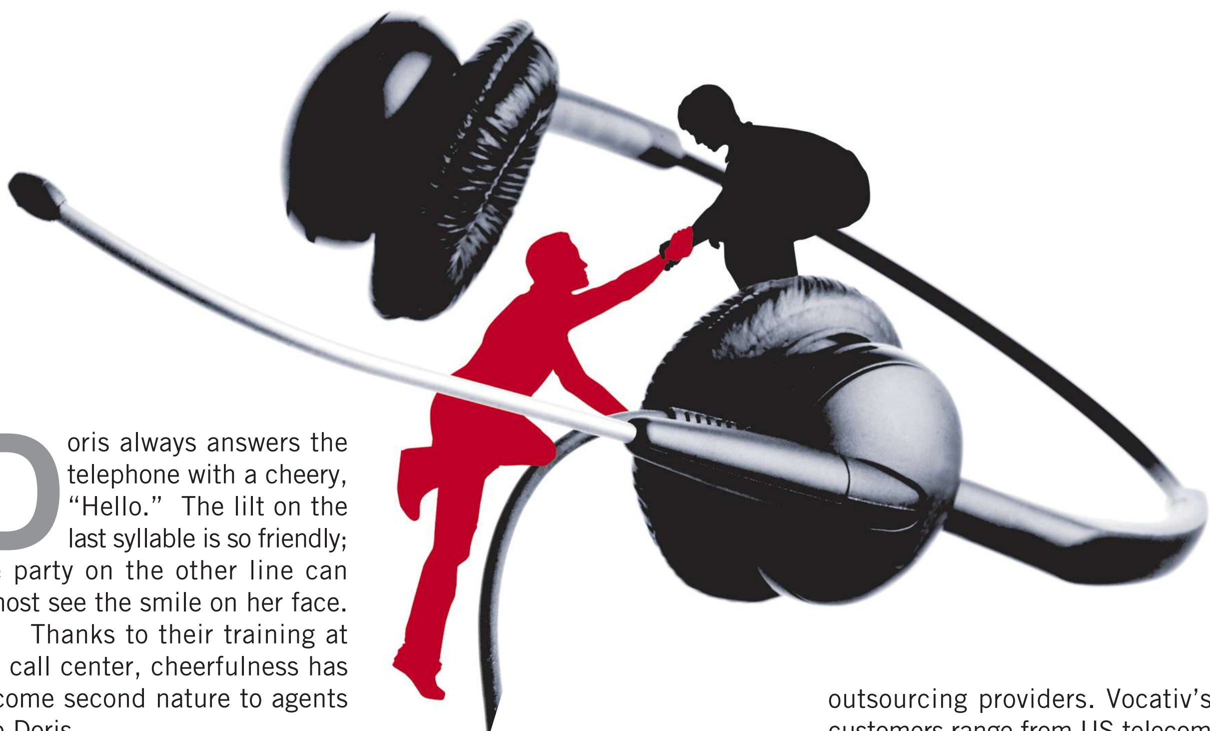
Over the past four years, *Netopia* has broadened its market appeal. Starting out with computer games, *Netopia* originally attracted a very young clientele. Over time, however, Internet usage has risen rapidly and so has the age of *Netopia* customers. Though *Netopia*'s strongest customers are still those under 25 years old, by the end of 2004 the above-25 market jumped to 38%, up from just 2% in 2000.

As a result, these days, "everyone comes to *Netopia*," says Carlo. He says children and teenagers come to play online games, young people come to chat and look for jobs, business people do research and relatives of overseas Filipino workers chat with their loved ones.

At the *Netopia* Greenbelt branch, the staff entertain a family of four – mom, dad and their two children every Sunday. They spend the day together, bonding via Internet games, taking advantage of the weekend flat rate.

# Say 'Hello'

## ePLDT CALL CENTERS RIDE THE WAVE



Doris always answers the telephone with a cheery, "Hello." The lilt on the last syllable is so friendly; the party on the other line can almost see the smile on her face.

Thanks to their training at the call center, cheerfulness has become second nature to agents like Doris.

In 2003, she joined Parlance Systems, Inc., an ePLDT call center, as a customer service representative, or CSR. Unlike her other fellow CSRs who were fresh college graduates at that time, Doris had some work experience. After graduating from one of the top universities in 1997, she worked in the HR department of a retail and trading company before taking a leap into the call center industry.

Parlance is a wholly-owned ePLDT call center facility that is dedicated to one US Fortune 500 company in the entertainment industry. It owns and operates a 1,000-seat call center facility with roughly 1,300 CSRs, providing inbound customer service support on billing inquiries and complaints, and other inquiries regarding pay per view, programming and installation. Parlance also handles outbound sales for the existing customers of this US client and goodwill calls for new customers. Towards mid-2004, Parlance started a BPO (back-end business processing operation) service that handles payment processing and process fulfillment services for its client.

ePLDT's first wholly-owned call center subsidiary, Vocativ Systems, Inc., or Vocativ, started full commercial operations in June 2002, some two months ahead of Parlance. This 750-seat call center facility with close to 900 CSRs is an alliance venture with one of the largest US-based global outsourcing providers. Vocativ's customers range from US telecom companies, computer hardware and software vendors, retail and e-commerce firms, and hotels.

ePLDT Ventus, Inc., or Ventus, the third ePLDT call center subsidiary located in Iloilo, went live in November 2004 with a US-based flower company as its first customer. It is a 300-seat call center facility located in Molo, Iloilo, built according to the same high standards and specifications as the Metro Manila call centers of ePLDT. It is the first ePLDT call center facility outside Metro Manila and the first major call center in Iloilo.

Iloilo is an ideal call center site since it is the educational center of West Visayas with 90,000 college-level students and producing about 14,000 graduates

## CALL CENTERS ARE A BOOMING BUSINESS THAT OFFER WELL-PAYING JOB OPPORTUNITIES FOR YOUNG GRADUATES AND GIVE THE COUNTRY A FOOT IN THE DOOR TO MORE LUCRATIVE BUSINESS PROCESS OUTSOURCING VENTURES.

annually. PLDT has also invested heavily in the Domestic Fiber Optic Network, or DFON, in Iloilo for traffic coming from Manila. Ventus now helps decongest Metro Manila by providing employment opportunities in Iloilo.

A fourth call center in Metro Manila under ePLDT Ventus is currently under construction. This 500-seat facility will be operational by November 2005.

The call center is a booming industry, one of the most progressive in today's economy.

Call centers offer exciting career alternatives for young graduates who stand to earn at least 40% more than their daytime counterparts while polishing their English and learning about a specific industry. One major recruitment channel that has been pioneered by ePLDT is its English/Call Center Fundamentals training tie-ups with universities in Metro Manila including Far Eastern University, Centro Escolar University, Jose Rizal University, Arellano University, Manuel L. Quezon University, Lyceum of the Philippines, and Adamson University. This training program, also called AMSPEAK, is likewise being implemented in three major universities in Iloilo, namely, Central Philippine University, University of San Agustin and West Visayas State University.

AMSPEAK trainers from ePLDT's Call Centers have conducted train-the-trainor workshops in order to share with university English teachers the desired conversational and grammatical approach to teaching Call Center Fundamentals in the academe.

The University of California, Irvine EASL (English As a Second Language) Department, developed the initial English training module specifically for PLDT.

"It was important to have a structured academic linguistic underpinning to the American speak program," says PLDT Senior Vice President and ePLDT Call Center Group Head Rose Montenegro. "The objective was not to sound American but rather to speak English correctly and to be understood by prospective American customers, coupled with the art of active listening and thinking on one's feet."

"Acquiring the American accent comes with the job. Once the CSRs have been exposed to taking calls from US customers, they pick-up the accent within a few weeks. That is an inherent Filipino talent, the ability to mimic accents and to learn a new language."

The Filipinos' proficiency in English and relatively high literacy rate make them the prime choice among Asians for outsourced customer contact center staff. Besides, Filipino CSRs are college graduates who bring a level of maturity and professionalism to the workforce.

Career and personal growth are also quite enhanced in the call center industry because, as Doris says, "seniority does not count at all."

What counts, she adds, are traits like flexibility and maturity to adapt to the American culture and a very strong willingness to help customers with their inquiries and even complaints, which are already inherent Filipino qualities.

The customer service industry offers employees a very good opportunity to learn fresh out of college. More than the communication skills they hone and the discipline they develop, employees imbibe the values of cultural relativism, that confidence in dealing with different cultures equally. When they are able to help people, and consequently bring goodwill to foreigners, the self-fulfillment they feel goes beyond the expected.

Being a CSR can really open doors and, as the song goes, "It starts with one hello," quips Doris.

**The Filipinos' proficiency in English and relatively high literacy rate make them the prime choice among Asians for outsourced customer contact center staff.**

# Refocusing Community Service

## HARNESSING CAPABILITIES AND TECHNOLOGIES FOR THE COMMON GOOD

The PLDT Group strengthened and refocused its community service initiatives in 2004. Leveraging on its strengths as the country's leading telecommunications conglomerate, the PLDT Group focused its corporate social responsibility programs on education, entrepreneurship and community building.

### ENRICHING EDUCATION

Smart, for example, extended its program for upgrading electronics and communications engineering (ECE) education to 43 colleges and universities all over the country.

Under the *Smart Wireless Engineering Education Program (SWEEP)*, Smart sets up in partner schools wireless laboratories featuring radio base stations and other cellular network equipment. Smart engineers train the schools' faculty on how to use the labs as a teaching facility. They also give lectures on the latest developments in wireless communications.

Since *SWEEP*'s launch in 2003, over 5,000 students have benefited from these wireless labs and over 500 teachers have been trained in their use. What has been the impact?

Oliver and Ronaldo, now ECE teachers at Bulacan State University, recall how hard it was to study engineering when they were still students. They relied mostly on textbook photos, occasional trips to a telecom company's facility and their fertile imagination to understand the course material. Now, Oliver and Ronaldo say their students are lucky. They can conduct experiments using the wireless lab.

Under its *Adopt-a-School Program*, PLDT works to bring information technology to remote, low-income municipalities. A case in point is the Kinagunan Ibaba National High School in Padre Burgos, Quezon province, a coastal town six hours away from Metro Manila. At the computer laboratory

# EDUCATION, ENTREPRENEURSHIP AND COMMUNITY BUILDING HAVE BECOME THE FOCAL POINTS OF COMMUNITY SERVICE FOR THE PLDT GROUP.

that was set up in the school in March 2004, students saw and learned to operate a computer for the first time.

Complementing this is PLDT's *Infoteach Program*, where public school teachers and students attend basic computer courses for free. To facilitate training, the sessions were held at *Netopia Internet Café* branches near the participating schools. Trainors were drawn from the faculty of the Asian College of Science and Technology, or ACSAT. A new program, *Infoteach* has already benefited some 150 students and teachers from various Metro Manila public high schools.

The PLDT Foundation, the social outreach arm of PLDT, has given out 75 educational grants to deserving elementary students who are dependents of rank and file and management employees of PLDT. The Foundation, through its MVP Excellence Awards, likewise rewarded 25 high school and 25 college students with scholarships in 2004.

The Foundation was also instrumental in bringing to the Philippines world-renowned inspirational speaker and management expert John Maxwell to teach leadership principles to some 18,000 Filipinos who attended his series of talks at the Araneta Center and the Philippine International Convention Center.

The PLDT Foundation envisions a Filipino citizenry empowered through education and Information and Communications Technology.

## UTILIZING GROUP STRENGTHS

Education has been favored as a field of community service because of its long-term benefits. Moreover, the PLDT Group's resources and capabilities are especially applicable to this field.

For example, PLDT's *Innovation Laboratory (Innolab)* facilities in Manila and Cebu City were set up to better serve corporate customers seeking to test new telecommunications solutions for their respective businesses. But these same facilities have become havens for students and academic researchers. Researchers from the University of the Philippines and the Department of Science and Technology, for example, will jointly work on projects covering rural telecommunications, Internet Protocol Version 6, mobile and wireless communications and broadband networking.

A newly established program, *Smart Schools*, utilizes the Group's unmatched capability to provide Internet connectivity for the benefit of public high school teachers and students.

Launched in December 2004 in partnership with the Philippine Business for Social Progress and Microsoft Philippines, the program aims to set up Teacher Learning Resource Centers equipped with Internet-enabled computer laboratories in 10 public high schools all over the country. It also aims to provide Internet links to 40 other public high schools with existing computer labs.

In this program, Internet connectivity will be supplied using PLDT's DSL network, Mabuhay's satellite facilities or Smart's wireless broadband system. The first three pilot schools chosen were in Malabon City in Metro Manila, Lapu Lapu City in Cebu and in Jolo, Sulu. At the same time, ePLDT's Internet Data Center will host online learning resources that teachers can access.

## ENCOURAGING ENTREPRENEURSHIP

Entrepreneurship was another major theme for community service in 2004. Again, it has been a case of putting the Group's capabilities to the service of the common good.

Take the case of Jon Pete, an enterprising student in a Davao City college. He went into business selling *Smart Load* (Smart's innovative electronic loading service for prepaid phones) and swapping SIM cards through the *Smart Entrepreneurship Program,* or *SEP*. He now earns as much as Php2,000 a day. With his earnings, the 24-year-old Marine student is able to help pay bills and save up to continue his studies. "In the *Smart Load* business, return on investment is fast," says Jon.

Launched in July 2004, *SEP* offers free seminars on entrepreneurship to college students and alumni of universities and colleges all over the country. *SEP* consists of three modules – Starting a Business, Financing the Business, and Business Opportunities Using Smart Products and Services. Smart has partnered with 32 schools for *SEP*.

More than 12,000 students and alumni have attended the *SEP* sessions, including Myrna, who gave up a 22-year employment with a bank to focus on being a *Smart Load* dealer.

"I was earning more on the *Smart Load* business than on my corporate job. I have no regrets. Now, I need not wake up early everyday, work eight hours away from home and pay huge parking fees. I can now give quality time

to my husband and two children," says Myrna.

She now runs a *Smart Load* center in her *sari-sari* store, where she also provides text and call services. She also maintains a network of *Smart Load* retailers, including an elderly woman who initially did not know anything about text messaging but is now her number one retailer.

## BUILDING COMMUNITIES

In 2004, PLDT and Smart actively participated in the community-building programs of the *Gawad Kalinga* Foundation. Their initial donation went to the construction of some 100 homes of the fire victims in Baseco Compound in Tondo, Manila, an urban poor community.

Smart employee volunteers joined residents in building homes at Baseco in December 2004. The Smart Amazing Village in Baseco Compound now has rows of houses painted in lively colors, and the formerly displaced people have a place they can call their own.

In the wake of the disastrous floods that hit Luzon in late 2004, Smart started a second Smart Amazing Village in General Nakar in Quezon province. About 600 employees – from executives to the rank and file – have volunteered to go to the town to help in rebuilding efforts over a 12-week period in early 2005.

Over the years, PLDT has also made a difference through its medical and dental missions in areas where residents cannot afford to regularly see a doctor.

In 2004, PLDT employee volunteers, accompanied by medical practitioners, trooped to several towns in Luzon region, diagnosing and giving medicine to more than 5,000 young and adult patients with ailments ranging from the common cold to asthma, iron deficiency and even diabetes. More than 1,000 malnourished and underweight children also benefited from the feeding programs. PLDT employees went to Pangasinan, Cagayan, Ilocos Sur, Benguet, Pampanga, Laguna, and in Payatas, Quezon City.

In many of these activities, employee volunteers have been instrumental. PLDT employees, for example, donated several hundred thousand pesos of their personal funds to the flood victims of Quezon and other Luzon provinces. Some of these employees went without their Christmas parties in order to raise funds for the victims.

Almost 7,000 pieces of toys, close to 700 articles of clothing, 65 books and 18 pairs of shoes were gathered from PLDT employees through the PLDT Foundation's Toy Swap Promo. These were all donated to various orphanages during the Christmas season.

Concerned about the environment, Smart employees joined several tree planting missions to Mt. Banahaw, which is undergoing rehabilitation, while others planted thousands of mangrove seedlings along the shoreline of Cordova, Cebu.

The PLDT Group also has volunteers trained by the Philippine National Red Cross prepared to assist in rescue operations and emergencies during disasters and calamities.

Community service is not just company policy—it is also the employees' commitment.

**During the year, Smart employee volunteers joined residents in building homes at Baseco while PLDT volunteer employees, accompanied by medical practitioners, trooped to several towns in Luzon, diagnosing and giving medicine to more than 5,000 patients.**

**Chairman Manuel V. Pangilinan himself celebrated his birthday on July 14 by going on a medical mission and feeding program in Payatas, Quezon City.**

## SETTING BEST PRACTICES IN CORPORATE GOVERNANCE

With the advent of new corporate governance laws and rules worldwide, PLDT has embarked on a systematic and deliberate process of adopting the best practices in corporate governance. This process will go through three phases: (1) compliance, (2) competencies and (3) character.

In the first phase, the objective is to comply with governance requirements through Group policy integration, process simplification, and systems redesign. This involves making our Group's policies, systems and processes coherent and consistent with relevant laws and regulatory rules.

The second phase is competencies. With changes that will take place as a result of policy integration, process simplification, and systems redesign, competencies of people in the PLDT organization must be reviewed and reassessed to align and support those changes. Internal controls are best achieved if people have the right and appropriate competencies to perform their assigned tasks in the appropriate manner.

The ultimate objective is to ensure that our Group's corporate image and reputation is a reflection of our corporate character. Like all business organizations, PLDT strives to generate returns for stakeholders. In the pursuit of that objective, we must also ensure that the interests of our key stakeholders (namely our shareholders, our employees, our customers and business partners, the community and the government and regulatory agencies) are properly addressed.

### INITIAL STEPS

By virtue of its listing in the Philippine and New York Stock Exchanges, PLDT falls under Philippine and U.S. regulatory requirements. In that regard, we have established various policies and initiatives to ensure that PLDT's business practices will be compliant with world-class best practices.

The initial steps were taken back in 2002. On September 24 of that year, our Board of Directors approved the PLDT Manual on Corporate Governance ("the Manual"), which took effect on January 1, 2003.

The Manual conforms with the requirements of the Philippine Securities and Exchange Commission, and covers policies on, among others: (a) independent directors, (b) key Board Committees (i.e., Audit Committee, Executive Compensation Committee, and Governance and Nomination Committee), (c) independent auditors, (d) internal audit, (e) stockholder rights, (f) internal controls, and (g) penalties for non-compliance.

On November 5, 2002, our Board of Directors approved the Anti-Money Laundering Manual. While PLDT is not a covered institution, we have nonetheless adopted it pursuant to our commitment to help the national government in preventing anti-money laundering activities.

### INITIATIVES IN 2004

In 2004, PLDT undertook major initiatives to further adopt best governance practices. On March 30, 2004, our Board approved the Code of Business Conduct and Ethics, or Code. The Code sets out standards of business conduct and ethics, namely, the standards of:

# Reflecting Corporate Character

(a) compliance, (b) competition and fair dealing, (c) confidentiality of information and proper use of property, (d) conflicts of interests and corporate opportunities, (e) disclosure, (f) risk management, and (g) relations with shareholders and investors.

These standards seek to promote the values of accountability, integrity, fairness and transparency. The Code also proscribes retaliation against reporters of violations of the Code, and penalizes violation of the prescribed standards.

With respect to adequate representation of independent directors in the Board, Philippine law requires publicly listed companies to have at least two independent directors or such independent directors shall constitute at least 20% of the members of the Board, whichever is fewer. PLDT has surpassed that standard by having four independent directors out of 13 directors elected in its June 2004 Annual Stockholders' Meeting.

PLDT has four working Board committees: the Governance and Nomination, Audit, Executive Compensation and Finance Committees. Each Committee has its own written charter covering the relevant Committee's composition, membership qualifications, functions and responsibilities, conduct of meetings, and reporting procedures to the Board.

The Governance and Nomination Committee is the result of the Board of Directors' commitment to corporate governance compliance when, in June 2004, it reconstituted and expanded the Nomination Committee to cover corporate governance-related oversight functions.

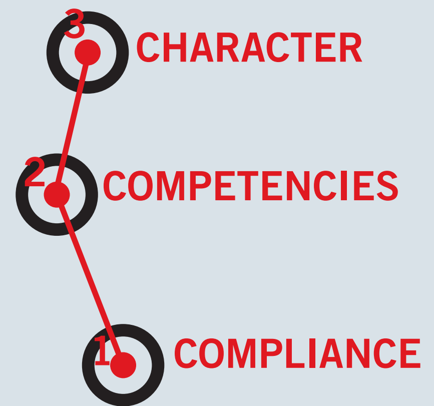
On January 27, 2005, we submitted our annual certification with the Philippine SEC confirming that:

- Compliance with SEC Memorandum Circular No. 2 dated April 5, 2002, as well as all relevant Circulars on Corporate Governance have been monitored;
- PLDT, its directors, officers and employees complied with all the leading practices and principles on good corporate governance as embodied in the Manual;
- PLDT also complied with its appropriate performance self-rating assessment and performance evaluation system to determine and measure compliance with the Manual;
- PLDT committed no major deviations from the provisions of the Manual; and
- A copy of the Manual had been furnished to the directors, officers, executives and employees.

## IN 2004, PLDT UNDERTOOK MAJOR INITIATIVES TO FURTHER ADOPT BEST GOVERNANCE PRACTICES.

### COMPLIANCE WITH THE U.S. SARBANES-OXLEY ACT

In the middle of June 2004, PLDT commenced its Sarbanes-Oxley 404 Compliance Project. Through this project, the PLDT Group ensures that its internal controls will support the annual internal control report on management's assessment of internal controls that must be certified by the chief executive officer and the chief financial officer starting 2006 for




foreign private issuers outside the U.S. like PLDT. This includes as well the required attestation of the independent external auditors.

On October 5, 2004, PLDT appointed its chief governance officer who serves as compliance officer and heads the Corporate Governance Office, which reports functionally to the Governance and Nomination Committee of the Board. The above initiatives are just the initial steps that PLDT is beginning to take in consonance with its commitment to good governance. With the Governance and Nomination Committee in place, as well as the CEO's support of the recently established and future corporate governance programs, PLDT will continue to pioneer the adoption of critical best practices in good corporate governance in the Philippines.

## PLDT IS AT THE START OF A NEW AND EXCITING ERA. FROM THAT PERSPECTIVE, THE CHALLENGES AND REWARDS OF BUILDING VALUE FOR OUR CUSTOMERS AND THE COUNTRY IS JUST BEGINNING.

(From left) Ricardo R. Zarate, Ray C. Espinosa, Christopher H. Young, Helen Y. Dee, Corazon S. de la Paz, Napoleon L. Nazareno, Manuel V. Pangilinan, Shigeru Yoshida, Antonio O. Cojuangco, Amado S. Bagatsing, Benny S. Santoso, Pedro E. Roxas, Rev. Fr. Bienvenido F. Nebres, S.J., Roberto R. Romulo, Oscar S. Reyes, Teresita T. Sy-Coson and Albert F. Del Rosario. (Not in photo: Sadao Maki.)

### ADVISORY BOARD/COMMITTEE

**Amado S. Bagatsing**
**Oscar S. Reyes**[1]
**Roberto R. Romulo**
**Benny S. Santoso**
**Christopher H. Young**
**Ricardo R. Zarate**

### AUDIT COMMITTEE

**Rev. Fr. Bienvenido F. Nebres, S.J.,** *Chairman*
**Pedro E. Roxas,** *Member*
**Oscar S. Reyes**[2], *Member*
**Juan B. Santos**[3], *Member*
**Corazon S. de la Paz,** *Advisor*
**Roberto R. Romulo,** *Advisor*
**Shigeru Yoshida,** *Advisor*

### EXECUTIVE COMPENSATION COMMITTEE

**Albert F. Del Rosario,** *Chairman*
**Ray C. Espinosa,** *Member*
**Pedro E. Roxas,** *Member*
**Oscar S. Reyes,** *Member*
**Shigeru Yoshida,** *Member*

## BOARD OF DIRECTORS[1]

**Manuel V. Pangilinan,** *Chairman*
**Napoleon L. Nazareno,** *President and CEO*
**Antonio O. Cojuangco**
**Helen Y. Dee**
**Ray C. Espinosa**
**Sadao Maki**
**Rev. Fr. Bienvenido F. Nebres, S.J.***
**Corazon S. de la Paz**
**Oscar S. Reyes***[2]
**Albert F. Del Rosario**
**Pedro E. Roxas***
**Teresita T. Sy-Coson***
**Shigeru Yoshida**

[1] *Each director owns less than 0.06% interest in PLDT.*

[2] *Elected effective April 5, 2005 to replace Juan B. Santos who resigned effective February 10, 2005.*

* *Independent Director*

### FINANCE COMMITTEE

**Corazon S. dela Paz,** *Chairman*
**Antonio O. Cojuangco,** *Member*
**Teresita T. Sy-Coson,** *Member*
**Amado S. Bagatsing,** *Member*
**Christopher H. Young,** *Member*
**Shigeru Yoshida,** *Advisor*

### GOVERNANCE & NOMINATION COMMITTEE

**Manuel V. Pangilinan,** *Chairman*
**Rev. Fr. Bienvenido F. Nebres, S.J.,** *Member*
**Juan B. Santos**[3]**,** *Member*
**Teresita T. Sy-Coson,** *Member*
**Shigeru Yoshida,** *Member*
**Rene G. Bañez,** *Non-voting Member*
**Victorico P. Vargas,** *Non-voting Member*

[1] *Elected as an independent director on April 5, 2005.*
[2] *Appointed effective April 5, 2005.*
[3] *Resigned effective February 10, 2005.*

# OFFICERS

**Napoleon L. Nazareno**
*President and CEO*

**Ernesto R. Alberto**
*Senior Vice President*

**Rene G. Bañez**
*Senior Vice President*

**Ma. Lourdes C. Rausa-Chan**
*Senior Vice President*

**Anabelle L. Chua**
*Senior Vice President*

**Menardo G. Jimenez, Jr.**
*Senior Vice President*

**George N. Lim**
*Senior Vice President*

**Rosalie R. Montenegro**
*Senior Vice President*

**Alfredo S. Panlilio**
*Senior Vice President*

**Claro Carmelo P. Ramirez**
*Senior Vice President*

**Ariel A. Roda**
*Senior Vice President*

**Victorico P. Vargas**
*Senior Vice President*

**Celso T. Dimarucut**
*First Vice President*

**Cesar M. Enriquez**
*First Vice President*

**Richard N. Ferrer**[1]
*First Vice President*

**Jun R. Florencio**
*First Vice President*

**Eriberto B. Gesalta**
*First Vice President*

**Florentino D. Mabasa, Jr.**
*First Vice President*

**Nerissa S. Ramos**[2]
*First Vice President*

**Raymond S. Relucio**
*First Vice President*

**Ramon B. Rivera, Jr.**
*First Vice President*

**Ricardo M. Sison**
*First Vice President*

**Emiliano R. Tanchico**
*First Vice President*

**Miguela F. Villanueva**
*First Vice President*

**(From left) Rene G. Bañez, Shigeru Yoshida, Claro Carmelo P. Ramirez, Alfredo S. Panlilio, Victorico P. Vargas, Christopher H. Young, Anabelle L. Chua, Menardo G. Jimenez, Jr., Tsuyoshi Kawashima, George N. Lim, Eriberto B. Gesalta, Florentino D. Mabasa, Jr., Ariel A. Roda, Ma. Lourdes C. Rausa-Chan, Cesar M. Enriquez, Ricardo M. Sison, Nerissa S. Ramos, Emiliano R. Tanchico, Rosalie R. Montenegro and Ernesto R. Alberto.**

**(From left) Ramon B. Rivera, Jr., Richard N. Ferrer, Jun R. Florencio, Raymond S. Relucio, Miguela F. Villanueva, Celso T. Dimarucut, Peter J. Lawrence, Ramon S. Fernandez, Don J. Rae, Anastacio R. Martirez, Rolando G. Peña, Helen T. Marquez, George H. Tan, Ray C. Espinosa, Emmanuel P. Dizon and Dave M. Simon.**

**Anna Isabel V. Bengzon**[3]
*Vice President*

**Alfredo B. Carrera**
*Vice President*

**Arnel S. Crisostomo**
*Vice President*

**Rebecca Jeanine R. De Guzman**
*Vice President*

**Mario C. Encarnacion**
*Vice President*

**Emeraldo L. Hernandez**
*Vice President*

**Joseph Nelson M. Ladaban**
*Vice President*

**Ma. Luz Natividad A. Lim**
*Vice President*

**Ramon Alger P. Obias**
*Vice President*

**Roberto G. Pador**[3]
*Vice President*

**Lilibeth F. Pasa**[3]
*Vice President*

**Enrique S. Pascual, Jr.**[3]
*Vice President*

**Jose Lauro G. Pelayo**[3]
*Vice President*

**Leo I. Posadas**
*Vice President*

**Ricardo C. Rodriguez**
*Vice President*

**Genaro C. Sanchez**[3]
*Vice President*

**Jesus M. Tañedo**
*Vice President*

**Jose Antonio T. Valdez**
*Vice President*

*[1] Appointed First Vice President effective January 1, 2005.*
*[2] Promoted to First Vice President effective January 25, 2005.*
*[3] Promoted to Vice President effective January 25, 2005.*

# PLDT Group Consolidated Net Income Up 65%; Earnings Reach Php9.4 Billion for First Quarter 2005

## Dividend of Php21/share Declared

Philippine Long Distance Telephone Company announced its financial results for the first quarter of 2005, reporting a consolidated net income of Php9.4 billion. In addition, the Company's Board of Directors also approved the payment of a Php21/share initial 2005 dividend to common shareholders with the target of achieving a 30% payout level of 2005 EPS. Payment will be made on 14th July 2005 to shareholders of record as of 3rd June 2005. This follows the dividend of Php14/share declared in respect of 2004 which is scheduled to be paid on 12th May 2005.

- **PLDT reports consolidated net income of Php9.4 billion for the first quarter 2005; adjusted net income at Php7.0 billion, taking into account effects of foreign exchange gains and derivative transactions.**
- **PLDT declares initial 2005 dividend to common shareholders of Php21/share.**
- **Cellular service revenues increase 11% as combined subscriber base surpasses 20 million.**
- **Consolidated EBITDA reaches Php18.5 billion; consolidated EBITDA margin improves to 63% of revenues.**
- **Consolidated free cash flow surges to Php11.3 billion, up from Php9.7 billion in the same period in 2004.**
- **PLDT Fixed Line reduces debt by US$155 million; consolidated debt declines by US$165 million.**
- **Smart to distribute Php20.0 billion to PLDT in 2005.**

Cellular subsidiaries, Smart Communications, Inc. ("Smart") and Pilipino Telephone Corporation ("Piltel"), contributed significantly to the rise in PLDT's consolidated net income. Without the impact of the peso's appreciation on foreign exchange translation and derivative transactions, adjusted consolidated net income rose to Php7.0 billion in the first quarter of 2005, 14% over the adjusted and restated net income of Php6.1 billion reported in the first quarter of 2004. Service revenues for the PLDT Group increased by 4% to Php29.4 billion while consolidated EBITDA improved to Php18.5 billion.

Consolidated free cash flow grew by 17%, from Php9.7 billion in the first quarter of 2004 to Php11.3 billion in the same period in 2005, enabling the Group to declare an initial 2005 dividend as well as reduce debts by US$165 million and remaining well on track to meet the 2005 debt reduction target of US$500 million.

### CELLULAR: ADAPTING TO MARKET CHANGES

Consolidated cellular service revenues increased to Php17.4 billion in the first quarter of 2005, 11% higher than the Php15.7 billion realized in the first quarter last year.

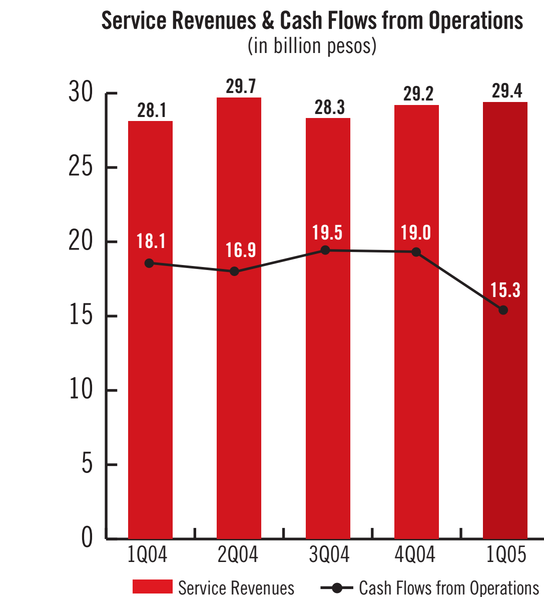
Consolidated cellular EBITDA grew by 7% to Php11.1 billion from Php10.3 billion. The

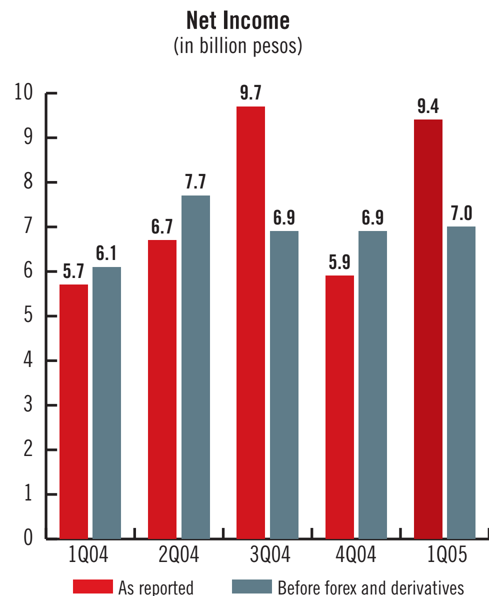
EBITDA margin stood at 64% in the first quarter of 2005 from 66% in the same period in 2004. Net income, as adjusted for the effects of the peso's appreciation on foreign exchange movements and derivative transactions, increased to Php5.8 billion from Php5.2 billion in the same period last year.

Net cellular activations totaled 1.04 million subscribers in the first quarter of 2005, bringing the PLDT Group's total cellular subscriber base to just over 20 million and maintaining its market share of about 58%. Smart added approximately 915,000 subscribers while *Talk 'N Text* added approximately 130,000 subscribers to end the quarter with 15.5 and 4.7 million subscribers, respectively. Net activations in the first quarter of 2004 were 26% higher at 1.4 million and it is expected that subscriber growth will decelerate compared to prior years' growth.

On March 11, 2005, Smart launched, for thirty days, the *Smart 258 Unlimited Call* and *Text* promo wherein Smart and *Talk 'N Text* prepaid subscribers could avail of unlimited on-network calls or text. The promotion was reinstituted on April 21 for another 30 days with some modifications.

Smart's cellular network has expanded to 36 switches and over 5,400 base stations covering 97% of the country's population. Capital expenditures were Php1.8 billion in the first quarter of 2005.

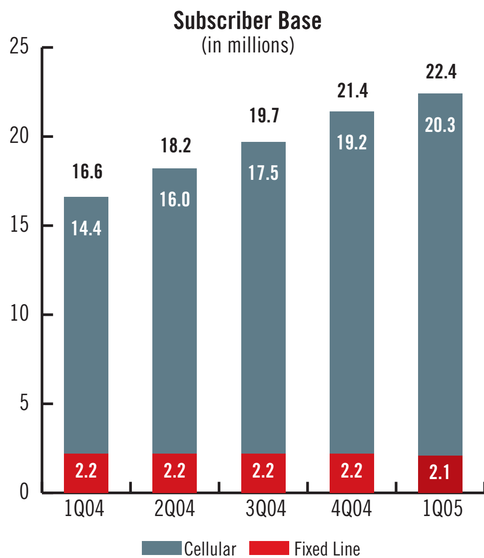



Free cash flow nearly doubled to Php9.0 billion in the first quarter of 2005 from Php4.6 billion in the first quarter of 2004. Smart intends to make a total distribution of Php20 billion to PLDT for 2005 – Smart paid a cash dividend of Php6.0 billion to PLDT in the first quarter of 2005; in addition, it will pay another Php8 billion in June and the balance in the second half of the year.

"As we had previously indicated, we have begun to see a slowing down of subscriber growth and we expect this trend to continue; a reflection, we believe of changing market dynamics as well as the effects of SIM-swap activities. Smart has in fact commenced winding down its SIM-swap activities and it is anticipated that although the industry will experience a temporary correction phase in terms of subscriber count, this should not, however, impact usage and our underlying revenues. It should, in fact, result in cost savings. Our mandate, therefore, as the industry leader, is to be responsive to these evolving conditions and find ways to actively develop new market segments whilst controlling costs. Our competitive advantage, in addition to our strong cash flows, is that we can do so not just within the wireless sphere but also in conjunction with the fixed and ICT businesses," explained Napoleon L. Nazareno, President and CEO of PLDT and Smart.

## THE SIGNIFICANT REVENUE GROWTH ACROSS ALL OUR BUSINESS SEGMENTS IS EXTREMELY ENCOURAGING AND WE FORESEE THIS POSITIVE TREND CONTINUING FOR THE REST OF THE YEAR.




### PLDT FIXED LINE: LOOKING AHEAD

Fixed Line service revenues decreased by 2% to Php11.8 billion in the first quarter of 2005, as the appreciation of the peso dampened local exchange and ILD revenues and the introduction of the "Php10 per call promotion" adversely affected NLD revenues. Launched in February 2005, the promotion offered a rate of Php10 per call to any PLDT landline number nationwide as well as to all Smart and *Talk 'N Text* subscribers. The declines in these segments were partially offset, however, by an increase in data revenues with the continued growth of broadband services and the introduction of new service offerings. On March 10, 2005, PLDT Fixed launched *PLDT WeRoam*, a wireless broadband service running on Smart's nationwide wireless network and utilizing GPRS/EDGE/Wi-Fi technologies. Aimed at the corporate market, *PLDT WeRoam* provides laptop-carrying employees with wireless data connectivity to their corporate Intranets and to the global Internet. DSL subscribers jumped to 72,700 at the end of the period, from 28,000 a year ago while other relatively new offerings such as *High Bandwidth Optical Service* and *Shops.work* have started to make headway and are expected to register a strong performance for the rest of the year.

Cash operating expenses were down 2%, reflecting the continued focus on various cash control initiatives. EBITDA was stable at Php6.8 billion as the decline in revenues was matched by a corresponding decline in cash

operating expenses. EBITDA margin improved slightly to 58% in the first quarter this year from 57% in the same period last year.

Capital expenditures for the first quarter of 2005 were at Php2.4 billion with the ongoing upgrade to an IP-based core network.

PLDT's free cash flow in the first three months of 2005 increased significantly by 61% to Php8.0 billion, mainly on account of the Php6.0 billion dividend from Smart. Accordingly, PLDT Fixed Line reduced its debts by US$155 million during the period, thus lowering its debt balance to US$1.8 billion as of the end of the first quarter of 2005. PLDT Fixed Line will continue to deleverage aggressively in 2005, thus saving on interest and financing costs and reducing its risk profile as well.

"Given the geographic coverage and bandwidth capabilities of our various networks, we feel we are well positioned to deploy the resources of the Group in a well-coordinated manner. We are looking to a new generation of services for PLDT, services such as *PLDT WeRoam* that bring together the strong corporate business of PLDT Fixed and the superior network capability of Smart," concluded Nazareno.

## ePLDT: HOLDING ITS OWN

ePLDT, the Group's information and communications technology arm, reported a profit of Php40 million for the first quarter of 2005.

Consolidated call center revenues grew by 53% to Php408 million as a result of continued growth in transaction volumes and increased capacity utilization. Combined call center seats grew to 2,870, an 81% increase over the same period last year. A third center call center in Iloilo commenced commercial operations in April 2005 with 400 seats.

Aside from the call centers, ePLDT's other business segments, which include *Netopia*™, *Vitro*™ Data Center and other Internet-related services, registered significant revenue improvements resulting in consolidated service revenues of Php652 million, a 50% increase compared to Php435 million in the same period last year.

"The significant revenue growth across all our business segments is extremely encouraging and we foresee this positive trend continuing for the rest of the year. We also expect ePLDT to play a strategic role not only in content development and aggregation for the Group but in the Group's transition to next generation services as well," said Ray C. Espinosa, ePLDT Managing Director.

## PLDT GROUP: TRANSFORMATION UNDERWAY

"At the end of 2004, the PLDT Group set for itself a number of financial and operational objectives. This early, I am pleased that we are well on our way to achieving a number of these goals. We have just announced an initial dividend to our common shareholders of Php21/share which should allow us to achieve our revised target of a 30% dividend payout level of 2005 EPS. The debt reduction of US$165 million in the first quarter of 2005 is a good start to achieving our goal of paying down US$500 million for the year. Most importantly, the transformation of the PLDT Group into a functionally integrated communications business has begun. Among other initiatives, the upgrading of our copper and fiber optic network into an IP-based one is underway as we prepare ourselves for the next wave of so-called 'disruptive technologies.' Certainly, we at PLDT have no intention of allowing these technologies to be self-fulfilling and disrupt our plans – the future is arriving fast and we are determined to be at the center of it," said Manuel V. Pangilinan, PLDT Chairman.

## CONSOLIDATED STATEMENTS OF INCOME

(in million pesos, except EPS) For the first quarter ended March 31,

| | 2005 | 2004 (a) |
|---|---|---|
| Income | | |
| Service Revenues | 29,361 | 28,107 |
| Non-service Revenues | 815 | 2,631 |
| Other Income | 75 | 85 |
| | 30,251 | 30,823 |
| Expenses | 17,325 | 23,107 |
| Income before income tax | 12,926 | 7,716 |
| Provision for income tax | 3,543 | 2,036 |
| Net Income - as reported | 9,361 | 5,686 |
| Net income before FX and derivatives (b) | 6,997 | 6,145 |
| EPS, Basic | 52.78 | 31.30 |
| EPS, Diluted | 47.57 | 31.30 |

(a) As restated to reflect adoption of International Accounting Standards.
(b) Net income excluding the net impact of gains/losses on FX and dervivative transactions.

# 2004 PLDT GROUP SIGNIFICANT EVENTS

## JANUARY

ePLDT *VITRO*™ Data Center hosts Level-Up! Philippines, the first online game publisher in the country.

Smart launches *Smart Infinity*, a premium postpaid plan targeting affluent individuals 35 years and above who are highly mobile locally and internationally.

Smart pioneers another service called *Smart Caller Ringtunes*, a service that allows a mobile phone user to customize the sound that people will hear when they call his number.

## FEBRUARY

The GSM Association awards *Smart Load* as "Best Mobile Application or Service for the Consumer Market" in Cannes, France.

## MARCH

Smart subscribers benefit from the flexibility provided by the *Smart Multi-line SIM, a*nother innovative service that allows subscribers to have up to five mobile numbers using just one SIM card.

## APRIL

*FinanceAsia* chooses PLDT/Smart as the Best Managed Company and the Best in Investor Relations in the Philippines. PLDT/Smart also placed 2nd for Best in Corporate Governance in the country.

## MAY

PLDT launches *IP Plus*, an affordable and flexible suite of three IP network solutions for corporate clients. These solutions are *IPSec*, or Internet Protocol Security; *IP VPN QoS*, or Internet Protocol - Virtual Private Network Quality of Service; and *VoVPN*, or Voice over Virtual Private Network.

PLDT inaugurates *InnoLab* in Cebu. *InnoLab*, or the Innovation Laboratory and Telecommunications Education Center of PLDT, is a laboratory and showroom where research and development projects involving telecommunications solutions can be implemented and organizations and companies can witness high-tech telecommunications solutions at work.

Smart is recognized as the "Asia Pacific Wireless Service Provider of the Year" during the Frost and Sullivan Asia Pacific Technology Awards 2004 in Singapore. *Smart Load* also wins the "Most Innovative Application of the Year" in the same event.

Smart introduces another postpaid plan, *Smart Kid*, in May 2004. *Smart Kid* is the first cellular service specially designed for kids aged 5-12 years old to keep them in touch with their parents and family members anytime, anywhere.

## JUNE

PLDT doubles speed of *PLDT myDSL* but retains price in a bid to strengthen its foothold in the broadband market.

*PLDT DSL* and *PLDT Vibe* subscribers flock to the newly-launched online gaming portal *PLDT Play*.

The new *PLDT Budget Card* begins to offer international long distance calls for as low as US$0.18 per minute to 89 destinations.

Telecom Asia, one of Asia's largest regional telecommunications publishing groups, awards PLDT as the Best Emerging Market Carrier in recognition of the Company's excellent financial and market performance.

## JULY

Smart launches the Smart Entrepreneurial Program (SEP) for college students and alumni of universities and colleges nationwide. SEP offers free seminars on entrepreneurship.

*Netopia* inaugurates its landmark 100th branch.

## AUGUST

*Netopia* opens a branch in Bangkok, Thailand, its first branch abroad.

Smart introduces another world-first– *Smart Padala*, the first and only international cash remittance through text. *Padala* is a Filipino household word akin to remittance, which is a means of financial support from the estimated 8 million family members or relatives working abroad.

Filipinos in Hong Kong begin to subscribe to *1528 SMART*, a prepaid GSM mobile phone service offering in Hong Kong designed and packaged to cater to the Filipino community. It is a partnership of Hong Kong CSL Ltd. and PLDT (HK) LTD./PLDT Global, in close collaboration with Smart.

## SEPTEMBER

Smart is recognized as the "Business of the Year" and "Innovator of the Year" for *Smart Load* during the 1st Raul Locsin Award for Business Excellence.

Smart enters into a Sale and Purchase Agreement to acquire 100% of Meridian Telekoms, Inc., a company primarily engaged in providing wireless broadband and data services to small and medium-scale businesses nationwide.

The Institutional Investor Asia Equities Market Report 2004 names PLDT as best in investor relations in the telecommunications sector. In addition, former PLDT President and CEO Manuel V. Pangilinan, who has recently assumed the position of chairman of PLDT's Board, is chosen in the survey as the Best CEO.

## OCTOBER

*PLDT On-Call*, the country's first comprehensive solution for clients in the call center industry, is launched. The solution diminishes entry barriers to the booming call center industry and helps control expenses for companies already into the business.

## NOVEMBER

PLDT launches *PLDT mySPOT* WiFi Network. This service paves the way for wireless broadband services in 2005.

*Netopia* opens Extreme Gaming Grounds (EGG) in cooperation with Intel. EGG is the first dedicated gaming facility in the country.

## DECEMBER

PLDT is again chosen by *Asiamoney* as the best-managed company in the country for two years in a row. The Company also tops the corporate governance poll and is overall most improved company for best management practices. President Napoleon L. Nazareno is also awarded as the Best CEO.

ePLDT Ventus, Inc., the third ePLDT call center, begins to train more agents in preparation for its full launch.

Smart completes its Php274-million transmission backbone facility in Palawan, providing 100% seamless coverage to all towns and municipalities in the province's mainland. The backbone, consisting of 21 relay stations stretched over a distance of 813 kilometers, will also service the requirements of other companies in the province.

PLDT unleashes the *"Abangan!"* campaign on December 24, 25 and 31 with a flat-rate offer of Php20 for all NDD calls from a PLDT landline to another PLDT landline.

# FINANCIAL REVIEW

## Management's Discussion And Analysis Of Financial Condition And Results Of Operations

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying consolidated financial statements and the related notes as at December 31, 2004 and 2003 and for each of the three years in the period ended December 31, 2004, included elsewhere in this Annual Report. This discussion contains forward-looking statements that reflect our current views with respect to future events and our future financial performance. These statements involve risks and uncertainties and our actual results may differ materially from those anticipated in these forward-looking statements.*

### Overview

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

- *Wireless* — wireless telecommunications services provided by Smart Communications, Inc., or Smart, and Pilipino Telephone Corporation, or Piltel, our cellular service providers, and Mabuhay Satellite Corporation, ACeS Philippines Cellular Satellite Corporation, and Telesat, Inc., our satellite and very small aperture terminal, or VSAT, operators;
- *Fixed Line* — fixed line telecommunications services primarily provided through PLDT. We also provide fixed line services through PLDT Clark Telecom, Inc., Subic Telecommunications Company, Inc., PLDT-Maratel, Inc., Piltel and Bonifacio Communications Corporation, which together account for approximately 3% of our consolidated fixed lines in service, and PLDT Global Corporation; and
- *Information and Communications Technology* — information and communications infrastructure and services for internet applications, internet protocol-based solutions and multimedia content delivery provided by PLDT's subsidiary ePLDT, Inc.; call center services provided by ePLDT's subsidiaries Parlance Systems, Inc., Vocativ Systems, Inc. and ePLDT Ventus, Inc.; internet access and gaming services provided by ePLDT's subsidiaries, Infocom Technologies, Inc., Digital Paradise, Inc. and netGames, Inc.; and e-commerce and IT-related services provided by other investees of ePLDT, as discussed in *Note 9 - Investments in Associates - at equity* to the accompanying consolidated financial statements.

### Summary Results of Operations

The table below shows the contribution of each of our business segments to our consolidated revenues and other income, expenses and net income (loss) attributable to equity holders for the years ended December 31, 2004, 2003 and 2002. Most of our revenues are derived from our operations in the Philippines. Our revenues derived from outside the Philippines consist primarily of revenues from incoming international calls and text messages to the Philippines.

| (in millions) | Wireless | Fixed Line | ICT | Inter-Segment Transactions | Total |
|---|---|---|---|---|---|
| **For the year ended December 31, 2004** | | | | | |
| Revenues and Other Income | Php80,057 | Php48,810 | Php2,415 | (Php5,030) | Php126,252 |
| Service | 69,349 | 48,486 | 2,080 | (4,661) | 115,254 |
| Non-service | 6,111 | – | 321 | (163) | 6,269 |
| Other income | 4,597 | 324 | 14 | (206) | 4,729 |
| Expenses | 48,381 | 46,943 | 3,038 | (5,030) | 93,332 |
| Net Income (Loss) Attributable to Equity Holders | 27,354 | 1,383 | (693) | – | 28,044 |
| **For the year ended December 31, 2003**[1] | | | | | |
| Revenues and Other Income | 65,780 | 47,175 | 1,893 | (2,565) | 112,283 |
| Service | 54,653 | 46,920 | 1,467 | (2,436) | 100,604 |
| Non-service | 10,548 | – | 316 | (150) | 10,714 |
| Other income | 579 | 255 | 110 | 21 | 965 |
| Expenses | 54,503 | 56,315 | 2,354 | (2,565) | 110,607 |
| Net Income (Loss) Attributable to Equity Holders | 9,625 | (7,118) | (384) | – | 2,123 |
| **For the year ended December 31, 2002**[1] | | | | | |
| Revenues and Other Income | 49,638 | 47,311 | 1,014 | (2,868) | 95,095 |
| Service | 36,670 | 46,411 | 773 | (1,761) | 82,093 |
| Non-service | 12,095 | – | 205 | (155) | 12,145 |
| Other income | 873 | 900 | 36 | (952) | 857 |
| Expenses | 53,653 | 58,100 | 1,672 | (2,868) | 110,557 |
| Net Income (Loss) Attributable to Equity Holders | (4,374) | (11,377) | (602) | – | (16,353) |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.

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

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

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

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

## 2004 Compared to 2003

## Accounting Changes

The accounting policies adopted are consistent with those of the previous financial year except that we have adopted the following new accounting standards effective for financial years beginning January 1, 2004 and accounting standards intended to be mandatory for financial years beginning on or after January 1, 2005. Prior years' consolidated financial statements here in have been restated to give effect to the provisions of the new standards adopted.

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

**PAS effective January 1, 2004:**

- ***PAS 12, "Income Taxes".*** PAS 12 prescribes the accounting treatment for deferred income taxes. This standard requires the use of the balance sheet liability method in accounting for deferred income taxes. It requires the recognition of a deferred tax liability and, subject to certain conditions, a deferred tax asset, for all temporary differences with certain exceptions. This standard provides for the recognition of a deferred tax asset when it is probable that taxable income will be available against which the deferred tax asset can be used. It also provides for the recognition of a deferred tax liability with respect to asset revaluations and fair value adjustments arising from business combinations.
- ***PAS 17, "Leases".*** PAS 17 requires the capitalization of finance leases, which transfer substantially all the risks and benefits incidental to ownership of leased item, at the inception of the lease at the fair value of leased property or, if lower, at the present value of the minimum lease payments. PAS 17 also requires that a lease, where the lessor retains substantially all the risks and benefits of ownership of the asset, be classified as operating leases, which should be recognized as an expense in the income statement on a straight-line basis over the lease term.

**PAS effective January 1, 2005:**

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

- ***PAS 32, "Financial Instruments: Disclosure and Presentation".*** PAS 32 covers the disclosure and presentation of all financial instruments. This standard requires more comprehensive disclosures about a company's financial instruments, whether recognized or unrecognized in the financial statements. New disclosure requirements include terms and conditions of financial instruments used, types of risks associated with both recognized and unrecognized financial instruments (market risk, price risk, credit risk, liquidity risk, and cash flow risk), fair value information of both recognized and unrecognized financial assets and financial liabilities, and our financial risk management policies and objectives. This standard also requires financial instruments to be classified as liabilities or equity in accordance with their substance and not their legal form. Consequently, we have designated PLDT's Convertible Preferred Stock Series V, VI and VII as compound instruments consisting of liability and equity components. The total fair value of the Convertible Preferred Stock Series V, VI and VII was determined at issue date, of which the aggregate fair value of the liability component of the Series V, VI and VII Convertible Preferred Stock as of date of issuance is included as a financial liability under *Note 18 - Interest-bearing Financial Liabilities* account in the consolidated balance sheets. The residual amount was assigned as the equity component.

- ***PAS 39, "Financial Instruments: Recognition and Measurement".*** PAS 39 establishes the accounting and reporting standards for recognizing and measuring our financial assets and financial liabilities. This standard requires a financial asset or financial liability to be recognized initially at cost, which is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability) for it. Subsequent to initial recognition, we are to continue to measure financial assets at their fair values, except for loans and receivables and held-to-maturity investments, which are measured at cost or amortized cost using the effective interest rate method. Financial liabilities are subsequently measured at cost or amortized cost, except for liabilities classified as "at fair value through profit and loss" and derivatives, which are measured at fair value.

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

- ***PAS 40, "Investment Property".*** PAS 40 prescribes the accounting treatment for investment properties which is defined as land and/or building held to generate income or for capital appreciation or both. An investment property is initially recognized at cost. Subsequent to initial recognition, an investment property is either carried at (i) cost, less accumulated depreciation or any accumulated impairment losses, or (ii) fair value, wherein fair value movements are recognized as income or expense. Transfers to or from investment property classification are made only when there is evidence of a change in use.

- ***PFRS 2, "Share-Based Payment".*** PFRS 2 requires an entity to recognize goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognize a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction. In line with our adoption of PFRS 2, we recognized in our consolidated statements of income the costs of employees' and directors' share options and other share-based incentives by using an option-pricing model, further details of which are given in *Note 22 - Employee Benefits* in the accompanying consolidated financial statements.

- ***PFRS 3, "Business Combinations", PAS 36, "Impairment of Assets" and PAS 38, "Intangible Assets".*** PFRS 3 requires all business combinations within its scope to be accounted for by applying the purchase method. In addition, this standard requires the acquirer to initially measure separately the identifiable assets, liabilities and contingent liabilities at their fair values, at acquisition date, irrespective of the extent of any minority interest.

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

- ***PFRS 5, "Non-Current Assets Held-for-Sale and Discontinued Operations".*** Under the superseded SFAS 35/IAS 35, *"Discontinuing Operations"*, we would have previously recognized a discontinued operation at the earlier of when (a) we enter into a binding agreement; and (b) the Board of Directors have approved and announced a formal disposal plan. PFRS 5 now requires an operation to be classified as discontinued when the criteria to be classified as held-for-sale have been met or we have disposed of the operation.

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

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

| | Equity | | | Net Income | | |
|---|---|---|---|---|---|---|
| | December 31, | | | For the years ended December 31, | | |
| (in millions, except per share amounts) | 2003 | 2002 | 2001 | 2003 | 2002 | 2001 |
| **As previously reported** | Php94,929 | Php88,936 | Php87,302 | Php11,182 | Php3,003 | Php2,699 |
| PAS 16 - Property, Plant and Equipment | (143) | (70) | (43) | (73) | (28) | (18) |
| PAS 17 - Leases | (562) | (547) | (458) | (15) | (88) | (90) |
| PAS 19 - Employee Benefits | (3,059) | (1,946) | (1,645) | (1,112) | (301) | (179) |
| PAS 21 - The Effects of Changes in Foreign Exchange Rates | (37,111) | (36,590) | (37,592) | (596) | 946 | 8,369 |
| PAS 27 - Consolidated and Separate Financial Statements | (19,446) | (16,424) | 952 | (3,445) | (17,581) | (8,321) |
| PAS 32 - Financial Instruments: Disclosure and Presentation | (14,481) | (12,811) | (11,792) | (1,775) | (1,353) | (3,590) |
| PAS 39 - Financial Instruments: Recognition and Measurement | 1,045 | 3,078 | 3,943 | (2,034) | (865) | 3,988 |
| PAS 40 - Investment Property | 236 | 254 | 265 | (18) | (10) | 49 |
| PFRS 2 - Share-Based Payment | - | - | - | 10 | (76) | (119) |
| PFRS 3 - Business Combinations, PAS 36 - Impairment of Assets and PAS 38 - Intangible Assets | 41 | - | - | (1) | - | - |
| **As restated** | Php21,449 | Php23,880 | Php40,932 | Php2,123 | (Php16,353) | Php2,788 |

| | Net Income | | |
|---|---|---|---|
| | For the years ended December 31, | | |
| | 2003 | 2002 | 2001 |
| **Earnings per common share, as previously reported** | Php55.74 | Php8.03 | Php7.10 |
| Earnings per share impact of restated items: | | | |
| PAS 16 - Property, Plant and Equipment | (0.43) | (0.16) | (0.11) |
| PAS 17 - Leases | (0.09) | (0.52) | (0.54) |
| PAS 19 - Employee Benefits | (6.57) | (1.78) | (1.06) |
| PAS 21 - The Effects of Changes in Foreign Exchange Rates | (3.52) | 7.06 | 49.62 |
| PAS 27 - Consolidated and Separate Financial Statements | (20.34) | (103.98) | (49.34) |
| PAS 32 - Financial Instruments: Disclosure and Presentation | (10.40) | (8.36) | (19.81) |
| PAS 39 - Financial Instruments: Recognition and Measurement | (10.57) | (5.12) | 23.65 |
| PAS 40 - Investment Property | (0.11) | 0.10 | 6.69 |
| PFRS 2 - Share-Based Payment | 0.06 | (0.45) | (0.71) |
| PFRS 3 - Business Combinations, PAS 36 - Impairment of Assets and PAS 38 - Intangible Assets | (0.01) | - | - |
| **Earnings per common share, as restated** | Php3.76 | (Php105.18) | Php15.49 |

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

## Results of Operations

### *Wireless*

#### Revenues and Other Income

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

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

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

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.

### *Service Revenues*

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

#### *Cellular Service*

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

Our cellular service revenues consist of:

- revenues derived from actual usage of the network by prepaid subscribers and any unused peso value of expired prepaid cards or electronic air time loads, net of discounts given to dealers;
- monthly service fees from postpaid subscribers, including (1) charges for calls in excess of allocated free local calls, (2) toll charges for national and international long distance calls, (3) charges for text messages of our service customers in excess of allotted free text messages, and (4) charges for value-added services, net of related content provider costs;
- revenues generated from incoming calls and messages to our subscribers, net of interconnection expenses; fees from reciprocal traffic from international correspondents; and revenues from inbound international roaming calls for the service; and
- other charges, including those for reconnection and migration.

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

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

Smart markets nationwide cellular communications services under the brand names *Smart Buddy, Smart Gold, addict mobile, Smart Infinity* and *Smart Kid. Smart Buddy, addict mobile prepaid,* or *amp,* and *Smart Kid prepaid* are prepaid services while *Smart Gold, addict mobile*, *Smart Infinity* and *Smart Kid* are postpaid services, which are all provided through Smart's digital network. *Smart Gold* was launched in April 1999 and remains Smart's most broadbased postpaid brand. Introduced in April 2003, *addict mobile* is aimed primarily at the 18-35 year olds in the higher and middle income markets. It offers exclusive multimedia content to subscribers and features personalized means for internet surfing, allowing subscribers to apply their allocated free credits towards their choice of data and value-added services. *Smart Infinity* is a premium postpaid plan, launched in January 2004, targeting affluent individuals 35 years and above who are highly mobile locally and internationally. It offers a round-the-clock dedicated personal concierge service, international assistance services, premium handset packages and exclusive lifestyle content. *Smart Kid*, launched in May 2004, is especially designed for children, ages 5 to 12 years old, and is equipped with “Family Finder” which automatically forwards the child's call to pre-assigned numbers on the phone, a location-based finder service to enable them to keep in touch with their family members,

as well as educational value-added services content. The prepaid versions of *addict mobile* and *Smart Kid* were introduced in October 2004.

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

In May 2003, Smart introduced *Smart Load*, an "over-the-air" electronic loading facility designed to make reloading of air time credits more convenient for, and accessible to consumers. These "over-the-air" reloads, which have both voice and text functions, are packaged in smaller denominations of Php30, Php60, Php115 and Php200, but have shorter validity periods of three days, six days, 12 days and 30 days, respectively. Starting with just 50,000 outlets when it was launched, *Smart Load's* distribution network now encompasses over 700,000 retail agents, approximately 90% of which are micro businesses. As at December 31, 2004, approximately 97% of Smart Buddy subscribers and 93% of *Talk 'N Text* subscribers were using *Smart Load* as their reloading mechanism. In 2004, *Smart Load* has accounted for approximately 71% of sales derived from reloads.

In December 2003, Smart introduced *Pasa Load* (literally meaning "transfer load"), a derivative service of *Smart Load* that allowed for Php10 load transfers to other *Smart Buddy* and *Talk 'N Text* subscribers. On January 25, 2004, denominations of Php2, Php5 and Php15 were added to the *Pasa Load* menu. All *Pasa Load* denominations have a one-day expiry period. We believe that *Smart Load* and *Pasa Load* encourage subscribers to stay within our cellular network instead of churning and re-subscribing at a later time. *Pasa Load* was also made available to Smart postpaid subscribers beginning April 18, 2004 with identical denominations to those offered to prepaid subscribers. The denominations have a similar one-day load expiry. The sender is billed the amount of the load and a Php1.00 transaction fee which is added on top of the monthly service fee.

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

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

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

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Refers to other non-subscriber-related revenues, consisting primarily of inbound international roaming fees, revenues from Smart Money Holdings Corporation and a small number of leased line contracts.

| | 2004 | 2003 | Increase Amount | % |
|---|---|---|---|---|
| Cellular subscriber base | 19,208,232 | 12,947,197 | 6,261,035 | 48 |
| Prepaid | 18,933,738 | 12,698,220 | 6,235,518 | 49 |
| Smart | 14,321,288 | 9,831,135 | 4,490,153 | 46 |
| Piltel | 4,612,450 | 2,867,085 | 1,745,365 | 61 |
| Postpaid | 274,494 | 248,977 | 25,517 | 10 |

| (in millions) | 2004 | 2003 | Increase Amount | % |
|---|---|---|---|---|
| Systemwide traffic volumes | | | | |
| Calls (in minutes) | 5,037 | 4,330 | 707 | 16 |
| Domestic | 3,576 | 3,021 | 555 | 18 |
| International | 1,461 | 1,309 | 152 | 12 |
| Inbound | 1,292 | 1,150 | 142 | 12 |
| Outbound | 169 | 159 | 10 | 6 |
| Text messages | 40,953 | 28,825 | 12,128 | 42 |
| Smart | 33,622 | 24,085 | 9,537 | 40 |
| Piltel | 7,331 | 4,740 | 2,591 | 55 |

*Voice Services*

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

Prior to January 2004, our prepaid subscribers were charged a rate of Php8.00 per minute for calls made during peak hours and Php4.00 per minute for calls made during off-peak hours regardless of whether the calls were made to subscribers within our network or to other mobile operators' networks. Beginning January 2004, we implemented all-day flat air time rates for calls made by our prepaid subscribers. *Smart Buddy* subscribers' calls terminating to subscribers within our network are charged Php6.50 per minute, while an all-day flat rate of Php7.50 per minute is charged for calls terminating to other cellular network subscribers as well as local and NDD calls. *Talk 'N Text* subscribers, on the other hand, are charged Php5.50 for calls made to subscribers within our network, while an all-day flat rate of Php6.50 are charged for calls terminating to other cellular network subscribers as well as local and NDD calls.

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

*Data Services*

Cellular revenues from data services, which include all text messaging-related services as well as value-added services, increased by Php9,841 million, or 44%, to Php31,965 million in 2004 from Php22,124 million in 2003. Cellular data services accounted for 48% of mobile cellular revenues in 2004, compared to 42% in 2003. Text messaging-related services contributed revenues of Php28,364 million in 2004, compared to Php20,426 million in 2003, and accounted for 89% and 92% of the total cellular data revenues for 2004 and 2003, respectively. The increase in revenues from text messaging-related services resulted mainly from a 42% increase in the volume of text messages to 40,953 million outbound messages in 2004 from the 28,825 million outbound messages handled in 2003. Value-added services contributed revenues of Php3,601 million in 2004, increasing by Php1,903 million, or 112%,from Php1,698 million in 2003.

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

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

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Value-added services developed by Smart on its own platform.

*Subscriber Base, ARPU and Churn Rates*

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

Our quarterly net subscriber activations over the last eight quarters of 2004 and 2003 are as follows:

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

Revenues attributable to our cellular prepaid service amounted to Php61,340 million in 2004, a 27% increase over the Php48,226 million earned in 2003. Prepaid service revenues in 2004 and 2003 accounted for 94% and 93%, respectively, of voice and data revenues. Revenues attributable to Smart's postpaid service amounted to Php4,195 million in 2004, a 20% increase over the Php3,492 million earned in 2003. Postpaid service revenues in 2004 and 2003 accounted for 6% and 7%, respectively, of voice and data revenues.

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

| | Gross | | Decrease | | Net | | Decrease | |
|---|---|---|---|---|---|---|---|---|
| | 2004 | 2003 | Amount | % | 2004 | 2003 | Amount | % |
| Prepaid | | | | | | | | |
| Smart | Php428 | Php521 | (Php93) | (18) | Php355 | Php425 | (Php70) | (16) |
| Piltel | 311 | 354 | (43) | (12) | 259 | 292 | (33) | (11) |
| Prepaid - Blended | 401 | 485 | (84) | (17) | 333 | 396 | (63) | (16) |
| Postpaid - Smart | 1,741 | 1,756 | (15) | (1) | 1,286 | 1,331 | (45) | (3) |
| Prepaid and Postpaid Blended | 424 | 512 | (88) | (17) | 349 | 416 | (67) | (16) |

Our quarterly prepaid and postpaid ARPUs over the last eight quarters of 2004 and 2005 are as follows:

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

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

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

Monthly ARPU for Smart's postpaid services is calculated in a manner similar to that of prepaid service, except that the revenues consist mainly of monthly service fees and charges on usage in excess of the monthly service fees.

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

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

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

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

The average monthly churn rate for Smart's postpaid subscribers for 2004 was 1.4%, compared to 3.0% in 2003. Smart's policy is to redirect outgoing calls to an interactive voice response system if the postpaid subscriber's account is either 45 days overdue or the subscriber has exceeded the prescribed credit limit. If the subscriber does not make a payment within 44 days of redirection, the account is disconnected. Within this 44-day period, a series of collection activities are implemented, involving the sending of a collection letter, call-out reminders and collection messages via text messaging.

***Satellite, VSAT and Other Services***

Our revenues from satellite, VSAT and other services consist mainly of rentals received for the lease of Mabuhay Satellite's transponders and Telesat's VSAT facilities to other companies and charges for ACeS Philippines' satellite phone service. Gross revenues from these services for 2004 amounted to Php1,958 million, an increase of Php255 million, or 15%, from Php1,703 million in 2003.

### *Non-service Revenues*

Our wireless non-service revenues consist of:

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

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

### *Other Income*

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

### Expenses

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

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

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

| (in millions) | 2004 | % | 2003[1] | % | Increase (Decrease) Amount | % |
|---|---|---|---|---|---|---|
| Wireless services | | | | | | |
| Cost of sales | Php11,122 | 23 | Php16,094 | 30 | (Php4,972) | (31) |
| Depreciation and amortization | 10,940 | 23 | 13,526 | 25 | (2,586) | (19) |
| Financing costs | 5,166 | 11 | 6,551 | 12 | (1,385) | (21) |
| Selling and promotions | 4,260 | 9 | 3,310 | 6 | 950 | 29 |
| Rent | 3,962 | 8 | 2,262 | 4 | 1,700 | 75 |
| Compensation and benefits[2] | 3,341 | 7 | 3,802 | 7 | (461) | (12) |
| Maintenance | 2,596 | 5 | 2,051 | 4 | 545 | 27 |
| Taxes and licenses | 1,214 | 2 | 1,174 | 2 | 40 | 3 |
| Professional and other service fees | 1,059 | 2 | 675 | 1 | 384 | 57 |
| Insurance and security services | 937 | 2 | 756 | 1 | 181 | 24 |
| Asset impairment | 430 | 1 | 2,589 | 5 | (2,159) | (83) |
| Provisions | 417 | 1 | 160 | - | 257 | 161 |
| Other expenses | 2,937 | 6 | 1,553 | 3 | 1,384 | 89 |
| Total | Php48,381 | 100 | Php54,503 | 100 | (Php6,122) | (11) |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Includes salaries and benefits, incentive plan, pension and MRP costs.

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

| (in millions) | 2004 | 2003 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Cost of cellular handsets and SIM-packs sold | Php10,839 | Php15,887 | (Php5,048) | (32) |
| Cost of satellite air time | 283 | 207 | 76 | 37 |
| | Php11,122 | Php16,094 | (Php4,972) | (31) |

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

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

| (in millions) | 2004 | 2003 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Accretion on financial liabilities - net | Php3,217 | Php2,387 | Php830 | 35 |
| Interest on loans and related items | 1,754 | 2,062 | (308) | (15) |
| Foreign exchange losses - net | 746 | 2,116 | (1,370) | (65) |
| Dividends on preferred stock subject to mandatory redemption | 284 | 254 | 30 | 12 |
| Financing charges | 1 | 32 | (31) | (97) |
| Capitalized foreign exchange losses | (6) | (70) | 64 | 91 |
| Loss (gain) on derivative transactions - net | (8) | 165 | (173) | (105) |
| Capitalized interest | (98) | (27) | (71) | (263) |
| Interest income | (724) | (368) | (356) | (97) |
| | Php5,166 | Php6,551 | (Php1,385) | (21) |

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

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

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

Maintenance expenses increased by Php545 million, or 27%, to Php2,596 million mainly on account of higher repairs and maintenance costs, and higher site utility expenses due to the continued growth in the number of cell sites and other network facilities.

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

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

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

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

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

| (in millions) | 2004 | 2003 | Increase Amount | % |
|---|---|---|---|---|
| Doubtful accounts | Php204 | Php72 | Php132 | 183 |
| Write-down of inventories at net realizable value | 213 | 88 | 125 | 142 |
| | Php417 | Php160 | Php257 | 161 |

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

### Provision for Income Tax

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

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

### Net Income

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

## *Fixed Line*

### Revenues and Other Income

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

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

| (in millions) | 2004 | % | 2003 [1] | % | Increase (Decrease) Amount | % |
|---|---|---|---|---|---|---|
| Fixed line services: | | | | | | |
| Service Revenues | | | | | | |
| Local exchange | Php20,799 | 43 | Php20,837 | 44 | (Php38) | – |
| International long distance | 12,803 | 26 | 12,735 | 27 | 68 | 1 |
| National long distance | 6,735 | 14 | 6,561 | 14 | 174 | 3 |
| Data and other network | 7,114 | 14 | 5,978 | 13 | 1,136 | 19 |
| Miscellaneous | 1,035 | 2 | 809 | 2 | 226 | 28 |
| | 48,486 | 99 | 46,920 | 100 | 1,566 | 3 |
| Other Income | 324 | 1 | 255 | - | 69 | 27 |
| Total Fixed Line Revenues | Php48,810 | 100 | Php47,175 | 100 | Php1,635 | 3 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.

## *Service Revenues*

### *Local Exchange Service*

Our local exchange service revenues consist of:

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

The following table summarizes key measures of our local exchange service business segment as at and for the years ended December 31, 2004 and 2003:

| | 2004 | 2003 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Consolidated local exchange service revenues (in millions) | Php20,799 | Php20,837 | (Php38) | – |
| Number of fixed lines in service | 2,152,027 | 2,185,951 | (33,924) | (2) |
| Number of fixed line employees | 9,692 | 10,518 | (826) | (8) |
| Number of fixed lines in service per employee | 222 | 208 | 14 | 7 |

Revenues from our local exchange service in 2004 decreased by Php38 million, to Php20,799 million from Php20,837 million in 2003. The decrease was primarily due to the (1) shift in subscriber preference from postpaid to prepaid services, which generate lower average revenue per subscriber, and (2) decline in installation revenues due to a promotion starting July 2003 which waived installation cost of subscribers in an effort to stimulate subscriber growth, partially offset by adjustments in our monthly local service rates. The percentage contribution of local exchange revenues to our total fixed line revenues decreased to 43% in 2004 from 44% in 2003.

Fixed line net reductions in 2004 was 33,924 as compared to 2,661 in 2003. While fixed line additions totaled 11,532 for prepaid fixed line services, postpaid fixed lines in service declined by 45,456 in 2004. As at December 31, 2004, postpaid and prepaid fixed line subscribers totaled 1,783,191 and 368,836, respectively, which accounted for approximately 83% and 17%, respectively, of total fixed lines in service.

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

A prepaid fixed line subscriber is recognized as an active subscriber when that subscriber activates and uses a prepaid call card. Prepaid fixed line subscribers can reload their accounts by purchasing call cards that are sold in denominations of Php500, Php300 and Php150. Reloads are valid for two months for the Php500 and Php300 cards. The lower denominated Php150 card, launched in

September 2003, has an account life of 15 days. A prepaid fixed line subscriber is disconnected if that subscriber does not reload within one month for the Php500 card, four months for the Php300 card, and 15 days for the Php150 card after the expiry of the last reload. All sales of prepaid cards, whether through dealers or through PLDT's business offices, are non-refundable.

Pursuant to a currency exchange rate adjustment mechanism authorized by the Philippine National Telecommunications Commission, or the NTC, we adjust our monthly local service rates upward or downward by 1% for every Php0.10 change in the peso-to-dollar exchange rate relative to a base rate of Php11.00 to US$1.00. During 2004, we implemented six upward and one downward adjustments in our monthly local service rates compared to 11 upward and three downward adjustments in 2003. The average peso-to-dollar rate in 2004 was Php56.044 to US$1.00, compared to the average of Php54.215 to US$1.00 in 2003. This change in the average peso-to-dollar rate translated to a peso depreciation of 3%, which resulted in an average net increase of 1.5% in our monthly local service rates in 2004.

***International Long Distance Service***

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

- inbound call revenues representing settlements from foreign telecommunications carriers for inbound international calls, virtual transit and hubbing service and reverse charged calls such as received collect and home country direct service;
- access charges paid to us by other Philippine telecommunications carriers for terminating inbound international calls to our local exchange network; and
- outbound call revenues representing amounts billed to our customers (other than our cellular customers) for outbound international calls, net of amounts payable to foreign telecommunications carriers for terminating calls in their territories.

The following table shows information about our international fixed line long distance business for the years ended December 31, 2004 and 2003:

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

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

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

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

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

Our outbound international long distance call volumes declined by 1% to 156 million minutes in 2004 from 158 million minutes in 2003, primarily due to cellular substitution (subscribers opting to use cellular for international outbound calls) and the popularity of alternative means of communications such as e-mailing, international text messaging and internet telephony.

***National Long Distance Service***

Our national long distance service revenues consist of:

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

The following table shows our national long distance service revenues and call volumes for the years ended December 31, 2004 and 2003:

| | 2004 | 2003 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Consolidated national long distance service revenues (in millions) | Php6,735 | Php6,561 | Php174 | 3 |
| National long distance call volumes (in million minutes) | 1,853 | 2,016 | (163) | (8) |

Our national long distance service revenues increased by Php174 million, or 3%, to Php6,735 million in 2004 from Php6,561 million in 2003 as a result of increased national direct dial, or NDD, rates and more beneficial interconnection agreements with cellular operators. Accordingly, the percentage contribution of national long distance revenues to our total fixed line revenues was 15% for 2004 and 2003.

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

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

Our national long distance call volumes, however, decreased by approximately 8% to 1,853 million minutes in 2004 from 2,016 million minutes in 2003. Cellular substitution and the widespread availability and growing popularity of alternative non-voice means of communications, particularly cellular text messaging and e-mailing, have negatively affected call volumes.

***Data and Other Network Services***

In 2004, our data and other network services posted revenues of Php7,114 million, an increase of Php1,136 million, or 19%, from Php5,978 million in 2003. The revenue contribution of this service segment to our total fixed line service revenues increased to 15% in 2004 from 13% in 2003.

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

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

Broadband/IP-based services accounted for 51%, traditional bandwidth services accounted for 44% and other services accounted for the remaining 5% of the total revenues from PLDT's data and other network services in 2004, compared to 44%, 50% and 6%, respectively, in 2003. These percentage changes indicate a continuing shift in data and other network revenues from traditional bandwidth services to broadband/IP-based services. We expect this trend to continue given the growing demand for broadband transmission of voice, data and video due to the continued growth of the internet, e-commerce and other online services.

PLDT offers two residential internet service packages targeting separate markets: *PLDT Vibe* for light to medium internet users and *DSL* broadband for heavy internet users. As at December 31, 2004, the number of PLDT's fixed line subscribers for *PLDT Vibe* stood at 369,435, of which 146,909 are exclusive postpaid users, 163,585 are exclusive prepaid users, and 58,941 are both postpaid and prepaid users, compared to 188,034 as at December 31, 2003, of which 110,502 were exclusive postpaid users, 58,939 were exclusive prepaid users, and 18,593 were both postpaid and prepaid users, while the number of *DSL* subscribers reached 49,476 and 23,884 as at December 31, 2004 and 2003, respectively.

In April 2004, PLDT introduced additional enhanced IP-based solutions under an umbrella brand *IP-Plus*, namely, *Quality of Service*, or *QoS*, *IP Security*, or *IP Sec*, and *Voice over Virtual Private Network*, or *VoVPN*. With *QoS*, customers are given priority service for voice, premium and basic, with the highest priority given to voice since it requires error-free transmission. *IP Sec* optimizes the latest encryption technology to ensure utmost confidentiality of vital information. *VoVPN* gives customers toll-grade quality without the cost of toll charges. All these *IP Plus* solutions translate to cost-efficiency, high reliability and increased security and flexibility.

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

***Miscellaneous***

Miscellaneous service revenues are derived mostly from directory advertising and facilities rental. In 2004, these revenues increased by Php226 million, or 28%, to Php1,035 million from Php809 million in 2003. The improvement was mainly due to an increase in co-location charges from more co-location sites coupled with an increase in rent income on duct utilization and cable restoration. Miscellaneous service revenues accounted for approximately 2% of our total fixed line revenues in 2004 and 2003, respectively.

### *Other Income*

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

### Expenses

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

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

| | | | | | Increase (Decrease) | |
|---|---|---|---|---|---|---|
| (in millions) | 2004 | % | 2003[1] | % | Amount | % |
| Fixed line services: | | | | | | |
| Financing costs | Php14,232 | 30 | Php18,782 | 34 | (Php4,550) | (24) |
| Depreciation and amortization | 10,125 | 21 | 9,767 | 17 | 358 | 4 |
| Compensation and benefits[2] | 7,792 | 17 | 10,507 | 19 | (2,715) | (26) |
| Provisions | 4,431 | 9 | 4,597 | 8 | (166) | (4) |
| Maintenance | 3,211 | 7 | 3,081 | 6 | 130 | 4 |
| Rent | 1,700 | 4 | 1,915 | 3 | (215) | (11) |
| Professional and other service fees | 1,181 | 3 | 1,129 | 2 | 52 | 5 |
| Selling and promotions | 1,160 | 2 | 1,054 | 2 | 106 | 10 |
| Taxes and licenses | 762 | 2 | 595 | 1 | 167 | 28 |
| Insurance and security services | 700 | 1 | 762 | 1 | (62) | (8) |
| Asset impairment | 366 | 1 | 2,846 | 5 | (2,480) | (87) |
| Other expenses | 1,283 | 3 | 1,280 | 2 | 3 | - |
| Total | Php46,943 | 100 | Php56,315 | 100 | (Php9,372) | (17) |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Includes salaries and benefits, incentive plan, pension and MRP costs.

Financing costs decreased by Php4,550 million, or 24%, to Php14,232 million due to lower interest expense and related items owing to lower debt balances in 2004 compared with 2003 and lower foreign exchange losses pertaining to: (1) the foreign exchange revaluation of the carrying values of financial liabilities as the level of peso depreciation was higher in 2003 as compared to 2004 and (2) designation and documentation of certain hedged items as hedged instruments to qualify for hedge accounting from July 2004 onwards. The breakdown of our financing costs for our fixed line business for the years ended December 31, 2004 and 2003 is as follows:

| | | | Increase (Decrease) | |
|---|---|---|---|---|
| (in millions) | 2004 | 2003 | Amount | % |
| Interest on loans and related items | Php10,699 | Php10,894 | (Php195) | (2) |
| Foreign exchange losses - net | 1,956 | 7,235 | (5,279) | (73) |
| Hedge cost | 1,011 | 1,054 | (43) | (4) |
| Loss on derivative transactions - net | 999 | 360 | 639 | 178 |
| Accretion on financial liabilities - net | 235 | 280 | (45) | (16) |
| Financing charges | 145 | 232 | (87) | (37) |
| Capitalized foreign exchange losses | (68) | (275) | 207 | 75 |
| Capitalized interest | (497) | (860) | 363 | 42 |
| Interest income | (248) | (138) | (110) | 80 |
| | Php14,232 | Php18,782 | (Php4,550) | (24) |

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

Compensation and benefits decreased by Php2,715 million, or 26%, to Php7,792 million mainly due to a 7% reduction in headcount due to PLDT's MRP in 2003, where MRP cost of Php1,885 million was recognized consequently; in 2004, MRP cost amounted to Php553 million. This decreasing effect was partially offset by collective bargaining agreement-related increases in salaries and benefits

of PLDT employees. See *Note 5 - Revenues and Expenses* to the accompanying consolidated financial statements for further discussion on PLDT's MRP.

Provisions decreased by Php166 million, or 4%, to Php4,431 million primarily on account of lower provisions by PLDT for anticipated uncollectible accounts from various specifically identified domestic telecommunications carriers which were provided for in 2003. In 2004, we made provisions for anticipated uncollectible accounts based on the aging profile of its accounts receivables. Our provision for doubtful accounts in 2004 and 2003 was equivalent to 3% and 4%, respectively, of its service revenues. The breakdown of provisions for our fixed line business for the years ended 2004 and 2003 is as follows:

| | | | Increase (Decrease) | |
|---|---|---|---|---|
| (in millions) | **2004** | **2003** | **Amount** | **%** |
| Doubtful accounts | Php3,751 | Php3,949 | (Php198) | (5) |
| Write-down of inventories at net realizable value | 361 | 238 | 123 | 52 |
| Onerous contracts | 319 | 410 | (91) | (22) |
| | Php4,431 | Php4,597 | (Php166) | (4) |

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

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

Professional and other service fees increased by Php52 million, or 5%, to Php1,181 million as a result of higher legal fees in 2004 for various services, partially offset by a decrease in number of consultants in line with PLDT's cost management efforts, coupled with a decrease in collection agency fees on account of lower final accounts subject for collection.

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

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

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

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

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

### Provision for (Benefit from) Income Tax

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

### Net Income (Loss)

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

## *Information and Communications Technology*

### Revenues and Other Income

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

In 2004, our information and communications technology business generated revenues of Php2,415 million, an increase of Php522 million, or 28%, from Php1,893 million in 2003. Going forward, we expect revenues from our call center and Internet and gaming businesses to continue to contribute significantly to our information and communications technology revenues with the growing demand for call center services.

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

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

### *Service Revenues*

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

#### *Call Center*

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

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

Call center revenues consist of:

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

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

- Vocativ's upward price adjustment for voice and voice over internet protocol, or VoIP, and an increase in programs being handled;
- expansion of programs and facilities and rapid ramp up of inbound calls resulting to the 505 or 36% increase in CSRs generating full time equivalents, or FTEs; and
- an upward price adjustment by Parlance for its inbound and outbound projects, coupled with an increase in the number of registered minutes.

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

#### *Internet 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 thru *DSL* or *NOW* cable internet; web consulting, development and hosting. The NOW cable internet brand was sold on February 1, 2005;
- a 67.79% interest in Digital Paradise, Inc., or DigiPar, an internet café business which assumed the assets of Netopia Computer Technologies, Inc. and brand of *Netopia*. *Netopia* is now one of the largest and fastest growing internet café chains in the country

with over 100 branches and over 6,000 work stations. DigiPar offers high-speed internet services, including internet advertising, gaming and printing; and

- a 63% interest in netGames, Inc., a publisher for Massively Multi-player Online Game, or MMOG, in the Philippines. netGames, which was incorporated on June 21, 2004, is the Philippine licensee of Khan Online, the country's first full 3D online game. netGames commenced full commercial operations in February 2005.

Internet Service revenues consist of:

- revenues derived from actual usage of internet access network by prepaid subscribers and any unused peso value of expired prepaid cards or electronic internet time loads, net of discounts given to dealers;
- monthly service fees from postpaid corporate and consumer subscribers, including (1) charges for internet usage in excess of allocated free plan internet hours; (2) one-time installation and activation fees; and (3) fees for value added services such as additional mailbox accounts;
- monthly service fees on value added services, including e-mail and web hosting services;
- one-time fees generated from resellership of internet-related solutions such as security solutions and domain registration; and
- share in revenues of text, voice and internet messages for cellular, landline and internet-based content and applications.

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

***Vitro™ Data Center***

ePLDT operates an internet data center under the brand name *Vitro*™. Granted pioneer status as an internet data center by the Philippine Board of Investments, or BOI, *Vitro*™ provides co-location services, server hosting, hardware and software maintenance services, website development and maintenance services, webcasting and webhosting, shared applications, data disaster recovery and business continuity services, intrusion detection, and security services such as firewall and managed firewall.

*Vitro*™ revenues consist of:

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

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

***Others***

Other revenues consist of:

- fees generated for issuance of digital certificates; and
- revenues derived from IT helpdesk/contact center solutions and terminals for credit, debit and credit card transactions.

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

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

### *Non-service Revenues*

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

### *Other Income*

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

### Expenses

Expenses associated with our information and communications technology business totaled Php3,038 million in 2004, an increase of

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

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

| | | | | | Increase (Decrease) | |
|---|---|---|---|---|---|---|
| (in millions) | 2004 | % | 2003[1] | % | Amount | % |
| Information and communications technology services: | | | | | | |
| Compensation and benefits[2] | Php892 | 29 | Php551 | 23 | Php341 | 62 |
| Asset impairment | 616 | 20 | 387 | 16 | 229 | 59 |
| Rent | 353 | 12 | 339 | 14 | 14 | 4 |
| Depreciation and amortization | 340 | 11 | 313 | 13 | 27 | 9 |
| Maintenance | 316 | 10 | 184 | 8 | 132 | 72 |
| Selling and promotions | 291 | 10 | 35 | 2 | 256 | 731 |
| Professional and other service fees | 64 | 2 | 65 | 3 | (1) | (2) |
| Financing costs | 22 | 1 | 53 | 2 | (31) | (58) |
| Taxes and licenses | 21 | 1 | 18 | 1 | 3 | 17 |
| Insurance and security services | 7 | - | 10 | - | (3) | (30) |
| Provisions | - | - | 82 | 4 | (82) | (100) |
| Other expenses | 116 | 4 | 317 | 14 | (201) | (63) |
| Total | Php3,038 | 100 | Php2,354 | 100 | Php684 | 29 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Includes salaries and benefits, incentive plan, pension and MRP costs.

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

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

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

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

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

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

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

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

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

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

Provisions decreased by Php82 million, or 100%, owing to specifically identified subscriber accounts of Infocom already provided for in 2003.

Other expenses decreased by Php201 million, or 63%, to Php116 million in line with our over-all cost containment initiatives.

### Provision for (Benefit from) Income Tax

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

### Net Loss

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

## 2003 Compared to 2002

## Accounting Changes

*Adoption of Statements of Financial Accounting Standards, or SFAS, 37/International Accounting Standards, or IAS, 37 "Provisions, Contingent Liabilities and Contingent Assets"*

The Accounting Standards Council, or ASC, approved the adoption of SFAS 37/IAS 37 "Provisions, Contingent Liabilities and Contingent Assets", which became effective in the Philippines for financial statements covering periods beginning on or after January 1, 2003. SFAS 37/IAS 37 requires that provisions be recognized when (i) an enterprise has a present obligation (legal or constructive) as a result of a past event; (ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (iii) a reliable estimate can be made of the amount of the obligation. SFAS 37/IAS 37 also provides that present obligations under onerous contracts are required to be recognized and measured as a provision. The Standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract.

SFAS 37/IAS 37 prescribes the retroactive adjustment to the opening balance of retained earnings for the period in which the Standard is first adopted. As allowed under the transitory provisions, we elected not to adjust the opening balance of retained earnings for the earliest period presented and not to restate comparative information.

We made a reasonable estimate of the amount necessary in the event the obligations stated below, and as discussed in *Note 24 – Provisions and Contingencies* to the accompanying financial statements, shall be settled and have made the appropriate provisions in our financial statements (see *Note 19 – Other Noncurrent Liabilities* to the accompanying consolidated financial statements in Item 7) as at December 31, 2003.

(i) NTC supervision and regulation fees;
(ii) Local business tax assessments; and
(iii) Air Time Purchase Agreement with AIL.

The effect of the application of SFAS 37/IAS 37 was a reduction of Php3,469 million in beginning retained earnings of 2003.

*Adoption of SFAS 38/IAS 38 "Intangible Assets"*

The ASC approved the adoption of SFAS 38/IAS 38 "Intangible Assets", which became effective in the Philippines for financial statements covering periods beginning on or after January 1, 2003. SFAS 38/IAS 38 requires that expenditures on research, start-up, training, advertising and relocation be expensed as incurred. Further, SFAS 38/IAS 38 prescribes the retroactive adjustment of unamortized intangible assets to the beginning retained earnings of 2003 and the restatement of comparative prior period financial statements.

As at January 1, 2003, ePLDT's and certain of its subsidiaries' consolidated unamortized preoperating expenses amounted to Php311 million, of which Php301 million, representing ePLDT's equity interest, was retroactively adjusted to the beginning retained earnings. Preoperating expenses incurred for the year ended December 31, 2003 were charged to operations. The effect of the application of SFAS 38/IAS 38 was a decrease of Php115 million in the consolidated net income for the year ended December 31, 2002 and reduction in beginning retained earnings amounting to Php301 million in 2003, and Php186 million in 2002. No tax effect adjustment was considered in the application of SFAS 38/IAS 38 due to income tax holiday incentives enjoyed by ePLDT and certain of its subsidiaries.

## Results of Operations

## *Wireless*

### Revenues and Other Income

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

The following table summarizes our service and non-service revenues and other income from our wireless business for the years ended December 31, 2003 and 2002 by service segment:

| (in millions) | 2003[1] | % | 2002[1] | % | Increase (Decrease) Amount | % |
|---|---|---|---|---|---|---|
| Wireless services: | | | | | | |
| Service Revenues | | | | | | |
| Cellular | Php52,950 | 80 | Php35,013 | 71 | Php17,937 | 51 |
| Satellite, VSAT and others | 1,703 | 3 | 1,657 | 3 | 46 | 3 |
| | 54,653 | 83 | 36,670 | 74 | 17,983 | 49 |
| Non-service Revenues | | | | | | |
| Sale of handsets and SIM-packs | 10,548 | 16 | 12,095 | 24 | (1,547) | (13) |
| Other Income | | | | | | |
| Gain on debt restructuring transaction | 80 | – | 103 | – | (23) | (22) |
| Others | 499 | 1 | 770 | 2 | (271) | (35) |
| | 579 | 1 | 873 | 2 | (294) | (34) |
| Total Wireless Revenues | Php65,780 | 100 | Php49,638 | 100 | Php16,142 | 33 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.

## *Service Revenues*

Our wireless service revenues increased by Php17,983 million, or 49%, to Php54,653 million in 2003 compared to Php36,670 million in 2002 mainly as a result of the continued growth of Smart's and Piltel's subscriber base. Accordingly, as a percentage of our total wireless revenues and other income, service revenues increased to 83% in 2003 from 74% in 2002.

### *Cellular Service*

Our cellular service revenues in 2003 amounted to Php52,950 million, an increase of Php17,937 million, or 51%, from Php35,013 million in 2002. The significant increase in our cellular service revenues in 2003 was largely driven by our large cellular subscriber base coupled with sustained subscriber growth.

The following table summarizes key measures of our cellular business as at and for the years ended December 31, 2003 and 2002:

| (in millions) | 2003[1] | 2002[1] | Increase Amount | % |
|---|---|---|---|---|
| Cellular service revenues | Php52,950 | Php35,013 | Php17,937 | 51 |
| Mobile | 52,768 | 34,889 | 17,879 | 51 |
| *By component* | *51,718* | *33,883* | *17,835* | *53* |
| Voice | 29,594 | 19,760 | 9,834 | 50 |
| Data | 22,124 | 14,123 | 8,001 | 57 |
| *By service type* | *51,718* | *33,883* | *17,835* | *53* |
| Prepaid | 48,226 | 32,007 | 16,219 | 51 |
| Postpaid | 3,492 | 1,876 | 1,616 | 86 |
| *Others*[2] | *1,050* | *1,006* | *44* | *4* |
| Satellite-based PCOs | 182 | 124 | 58 | 47 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 – Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Refers to other non-subscriber-related revenues consisting primarily of inbound international roaming fees, revenues from Smart Money Holdings Corporation and a small number of leased line contracts.

| | 2003 | 2002 | Increase Amount | % |
|---|---|---|---|---|
| Cellular subscriber base | 12,947,197 | 8,599,306 | 4,347,891 | 51 |
| Prepaid | 12,698,220 | 8,422,658 | 4,275,562 | 51 |
| Smart | 9,831,135 | 6,649,038 | 3,182,097 | 48 |
| Piltel | 2,867,085 | 1,773,620 | 1,093,465 | 62 |
| Postpaid | 248,977 | 176,648 | 72,329 | 41 |

| | 2003 | 2002 | Increase Amount | % |
|---|---|---|---|---|
| Systemwide traffic volumes (in millions) | | | | |
| Calls (in minutes) | 4,330 | 3,257 | 1,073 | 33 |
| Domestic | 3,021 | 2,293 | 728 | 32 |
| International | 1,309 | 964 | 345 | 36 |
| Inbound | 1,150 | 832 | 318 | 38 |
| Outbound | 159 | 132 | 27 | 20 |
| Text messages | 28,825 | 19,560 | 9,265 | 47 |
| Smart | 24,085 | 16,536 | 7,549 | 46 |
| Piltel | 4,740 | 3,024 | 1,716 | 57 |

*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 Php9,834 million, or 50%, to Php29,594 million in 2003 from Php19,760 million in 2002 mainly due to the increase in subscriber base, as well as the increase in inbound international long distance revenues.

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

*Data Services*

Smart's revenues from cellular data services, which include all text messaging-related services as well as value-added services, increased by Php8,001 million, or 57%, to Php22,124 million in 2003 from Php14,123 million in 2002. Cellular data services accounted for 42% of our cellular revenues in 2003 and 40% in 2002. Text messaging-related services contributed revenues of Php20,426 million in 2003, compared to Php13,412 million in 2002, and accounted for 92% and 95% of the total cellular data revenues for 2003 and 2002, respectively. The increase in revenues from text messaging-related services resulted mainly from a 47% increase in volume of text messages to 28,825 million outbound messages in 2003 from the 19,560 million outbound messages handled in 2002. Value-added services contributed revenues of Php1,698 million in 2003, increasing by Php987 million, or 139%, from Php711 million in 2002.

The following table shows the breakdown of Smart's cellular data revenues for the years ended December 31, 2003 and 2002:

| (in millions) | 2003[1] | 2002[1] | Increase Amount | % |
|---|---|---|---|---|
| Text messaging | | | | |
| Domestic | Php18,392 | Php12,060 | Php6,332 | 53 |
| International | 2,034 | 1,352 | 682 | 50 |
| | 20,426 | 13,412 | 7,014 | 52 |
| Value-added services | | | | |
| Non-Zed[2] | Php767 | Php390 | Php377 | 97 |
| Smart Zed™ | 665 | 259 | 406 | 157 |
| Mobile Banking, Roaming SMS, WAP, *Smart Money* | 266 | 62 | 204 | 329 |
| | 1,698 | 711 | 987 | 139 |
| Total | Php22,124 | Php14,123 | Php8,001 | 57 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 – Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Value-added services developed by Smart on its own platform.

*Subscriber Base, ARPU and Churn Rates*

Of our 12,947,197 subscribers as at December 31, 2003, prepaid subscribers accounted for 98% while postpaid subscribers accounted for the remaining 2%. Cellular prepaid subscriber base grew by 51% to 12,698,220 as at December 31, 2003 from 8,422,658 as at December 31, 2002, whereas Smart's postpaid GSM subscriber base increased by 41% to 248,977 as at December 31, 2003 from 176,648 as at December 31, 2002. Cellular prepaid and postpaid net subscriber activations totaled 4,275,562 and 72,329, respectively, in 2003, or a monthly average addition of 356,297 prepaid and 6,027 postpaid subscribers.

Our quarterly net subscriber activations for each of the quarters of 2003 and 2002 are as follows:

| | GSM | | | Analog | | | | |
|---|---|---|---|---|---|---|---|---|
| | Prepaid | | Postpaid | Prepaid | Postpaid | Prepaid | Postpaid | |
| | Smart | Piltel | Smart | Smart | | Piltel | | Total |
| **2003** | | | | | | | | |
| First Quarter | 527,158 | 205,086 | 36,963 | – | – | – | – | 769,207 |
| Second Quarter | 744,251 | 241,630 | 9,331 | – | – | – | – | 995,212 |
| Third Quarter | 858,723 | 319,528 | 8,816 | – | – | – | – | 1,187,067 |
| Fourth Quarter | 1,051,965 | 327,221 | 17,219 | – | – | – | – | 1,396,405 |
| **2002** | | | | | | | | |
| First Quarter | 411,540 | 249,352 | 4,578 | (31,704) | (4,008) | (20,900) | (799) | 608,059 |
| Second Quarter | 230,947 | 33,742 | 12,175 | (20,112) | (3,281) | (26,632) | (889) | 225,950 |
| Third Quarter | 605,902 | 61,686 | 42,428 | (16,297) | (3,408) | (12,671) | (536) | 677,104 |
| Fourth Quarter | 831,033 | 99,514 | 45,417 | (19,316) | (154,052) | (16,270) | (66,983) | 719,343 |

Revenues attributable to our cellular prepaid service amounted to Php48,226 million in 2003, a 51% increase over the Php32,007 million earned in 2002. Net prepaid revenues in 2003 accounted for 93% of voice and data revenues, compared to 94% in 2002. Revenues attributable to our cellular postpaid service amounted to Php3,492 million in 2003, an 86% increase over the Php1,876 million earned in 2002. Net postpaid revenues in 2003 accounted for 7% of voice and data revenues, compared to 6% in 2002.

The following table summarizes our usage-based monthly ARPUs for the years ended December 31, 2003 and 2002:

| | Gross | | Decrease | | Net | | Increase (Decrease) | |
|---|---|---|---|---|---|---|---|---|
| | 2003 | 2002 | Amount | % | 2003 | 2002 | Amount | % |
| Prepaid | | | | | | | | |
| Smart | Php521 | Php585 | (Php64) | (11) | Php425 | Php446 | (Php21) | (5) |
| Piltel | 354 | 358 | (4) | (1) | 292 | 278 | 14 | 5 |
| Prepaid – Blended | 485 | 532 | (47) | (9) | 396 | 407 | (11) | (3) |
| Postpaid – Smart | 1,756 | 1,999 | (243) | (12) | 1,331 | 1,439 | (108) | (8) |
| Prepaid and Postpaid Blended | 512 | 553 | (41) | (7) | 416 | 422 | (6) | (1) |

Our quarterly prepaid and postpaid ARPUs over the last eight quarters of 2003 and 2002 are as follows:

| | Prepaid | | | | Postpaid | |
|---|---|---|---|---|---|---|
| | Smart | | Piltel | | Smart | |
| | Gross | Net | Gross | Net | Gross | Net |
| **2003** | | | | | | |
| First Quarter | Php533 | Php416 | Php351 | Php273 | Php1,716 | Php1,268 |
| Second Quarter | 527 | 426 | 362 | 299 | 1,751 | 1,336 |
| Third Quarter | 490 | 404 | 345 | 292 | 1,756 | 1,332 |
| Fourth Quarter | 535 | 454 | 359 | 303 | 1,800 | 1,385 |
| **2002** | | | | | | |
| First Quarter | Php575 | Php446 | Php353 | Php272 | Php2,033 | Php1,488 |
| Second Quarter | 587 | 418 | 350 | 267 | 2,133 | 1,383 |
| Third Quarter | 590 | 450 | 354 | 253 | 1,990 | 1,485 |
| Fourth Quarter | 587 | 469 | 374 | 318 | 1,839 | 1,402 |

Smart's prepaid service revenues consist mainly of charges for subscribers' actual usage of their prepaid cards. Gross monthly ARPU for Smart's prepaid GSM service in 2003 was Php521, compared to Php585 in 2002. The decline was attributable mainly to decreases of Php22 and Php18 in the average outbound and inbound local voice revenue per subscriber, respectively, and a Php16 decreased in the average data revenue per subscriber in 2003. On a net basis, ARPU in 2003 decreased by 5% to Php425 from Php446 in 2002. The lower rate of decrease in net ARPU compared to the decrease in gross ARPU resulted from lower average interconnection expense per subscriber due to an increasing percentage of Smart-to-Smart traffic to total voice traffic, to 61% in 2003 from 55% in 2002, as well as lower dealer discounts on *Smart Load.* Smart expects its prepaid ARPUs to continue to decline now that lower-denomination reloads are available and as it continues its expansion into the lower end of the market.

Gross monthly ARPU for postpaid subscribers in 2003 was Php1,756, compared to Php1,999 in 2002. On a net basis, postpaid ARPU decreased by 8% to Php1,331 in 2003 from Php1,439 in 2002. Our monthly gross blended ARPU was Php512 in 2003, compared to Php553 in 2002. Blended net monthly ARPU decreased by 1% to Php416 in 2003 from Php422 in 2002.

For *Smart Buddy*, the average monthly churn rate for 2003 was 2.9%, compared to 3.2% in 2002. In line with the various churn management initiatives implemented to address increased churn rates, Smart launched *PureTxt 100* in August 2002. *PureTxt 100* was originally a text-only card with a denomination of Php100 intended for *Smart Buddy* subscribers. In May 2003, Smart introduced *Smart Load*, an "over-the-air" electronic loading facility designed to make reloading of air time credits more convenient for, and accessible to consumers. These "over-the-air" reloads, which have both voice and text functions, are packaged in smaller denominations of Php30, Php60, Php115 and Php200, but have shorter validity periods of three days, six days, 12 days and 30 days, respectively. Starting with just 50,000 outlets when it was launched, *Smart Load's* distribution network now encompasses over 400,000 retail agents, approximately 80% of which are micro businesses. As at December 31, 2003, 77% of *Smart Buddy* subscribers were using *Smart Load* as their reloading mechanism with daily transactions in December averaging 2.3 million. In the period since its launch, *Smart Load* has accounted for approximately 45% of sales derived from reloads.

On December 24, 2003, Smart introduced *Pasa Load* (the term "pasa" means "transfer" in the vernacular), a derivative service of *Smart Load* that allows for Php10 load transfers to other *Smart Buddy* and Piltel *Talk 'N Text* subscribers. On January 25, 2004, denominations of Php2, Php5 and Php15 were added to the *Pasa Load* menu. All *Pasa Load* denominations have a one-day expiry period. Like *PureTxt 100*, we believe that *Smart Load* and *Pasa Load* will encourage subscribers to stay within our cellular network instead of churning and re-subscribing at a later time. As a result of the launch of *Smart Load*, we have ceased the production and sale of *PureTxt 100* cards.

The average monthly churn rate for Smart's postpaid GSM subscribers in 2003 was 3.0%, compared to 2.3% in 2002. Smart's policy is to redirect outgoing calls to an interactive voice response system if the postpaid subscriber's account is either 45 days overdue or the subscriber has exceeded the prescribed credit limit. If the subscriber does not make a payment within 44 days of redirection, the account is disconnected. Within this 44-day period, a series of collection activities are implemented, involving the sending of a collection letter, call-out reminders and collection messages via text messaging.

#### *Satellite, VSAT and Other Services*

Our revenues from satellite, VSAT and other services consist mainly of rentals received for the lease of Mabuhay Satellite's transponders and Telesat's VSAT facilities to other companies and charges for ACeS Philippines' satellite phone service. Total revenues from these services in 2003 amounted to Php1,703 million, an increase of Php46 million, or 3%, from Php1,657 million in 2002.

### *Non-service Revenues*

Our wireless non-service revenues decreased by Php1,547 million, or 13%, to Php10,548 million in 2003 as compared to Php12,095 million in 2002 mainly attributable to lower handset sales. In 2003, activations were driven by more SIM-pack sales and SIM-swap activities.

### *Other Income*

Our wireless business segment generated other income of Php579 million in 2003, a decrease of Php294 million, or 34%, from Php873 million in 2002. This decrease was primarily due to a gain on sale of assets and management fees coupled with lower gain on debt restructuring transaction in 2003 compared to 2002.

### Expenses

Expenses associated with our wireless business in 2003 amounted to Php54,503 million, an increase of Php850 million, or 2%, from Php53,653 million in 2002. A significant portion of this increase was attributable mainly to depreciation and amortization, compensation and benefits and selling and promotions. As a percentage of our wireless revenues and other income, expenses associated with our wireless business decreased to 83% in 2003 from 108% in 2002.

Cellular business expenses accounted for 92% and 97%, while satellite, VSAT and other business expenses accounted for 8% and 3% of our wireless business expenses in 2003 and 2002, respectively.

The following table summarizes our wireless-related expenses for the years ended December 31, 2003 and 2002 and the percentage of each expense item to the total:

| (in millions) | 2003[1] | % | 2002[1] | % | Increase (Decrease) Amount | % |
|---|---|---|---|---|---|---|
| Wireless services | | | | | | |
| Cost of sales | Php16,094 | 30 | Php17,281 | 32 | (Php1,187) | (7) |
| Depreciation and amortization | 13,526 | 25 | 11,041 | 21 | 2,485 | 23 |
| Financing costs | 6,551 | 12 | 7,008 | 13 | (457) | (7) |
| Compensation and benefits[2] | 3,802 | 7 | 2,712 | 5 | 1,090 | 40 |
| Selling and promotions | 3,310 | 6 | 2,504 | 5 | 806 | 32 |
| Asset impairment | 2,589 | 5 | 4,756 | 9 | (2,167) | (46) |
| Rent | 2,262 | 4 | 2,010 | 4 | 252 | 13 |
| Maintenance | 2,051 | 4 | 1,387 | 3 | 664 | 48 |
| Taxes and licenses | 1,174 | 2 | 572 | 1 | 602 | 105 |
| Insurance and security services | 756 | 1 | 694 | 1 | 62 | 9 |
| Professional and other service fees | 675 | 1 | 1,344 | 2 | (669) | (50) |
| Provisions | 160 | – | 992 | 2 | (832) | (84) |
| Other expenses | 1,553 | 3 | 1,352 | 2 | 201 | 15 |
| Total | Php54,503 | 100 | Php53,653 | 100 | Php850 | 2 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Includes salaries and benefits, incentive plan, pension and MRP costs.

Cost of sales decreased by Php1,187 million, or 7% to Php16,094 million as activations in 2003 were driven more by SIM-pack sales and SIM-swap activities compared to handset sales in 2002 partially offset by an increase in satellite air time cost by Php157million, or 314%, to Php207 million due to the change in basis of recognizing air time cost. In 2003, satellite air time cost was accrued at a fixed amount per month based on the payment schedule in a standstill agreement in consideration for unlimited air time access. Please see *Note 21 – Related Party Transactions* and *Note 24 – Provisions and Contingencies* to the accompanying consolidated financial statements for further discussion. The breakdown of cost of sales for our wireless business for the years 2003 and 2002 are as follows:

| (in millions) | 2003 | 2002 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Cost of cellular handsets and SIM-packs sold | Php15,887 | Php17,231 | (Php1,344) | (8) |
| Cost of satellite air time | 207 | 50 | 157 | 314 |
| | Php16,094 | Php17,281 | (Php1,187) | (7) |

Depreciation and amortization charges increased by Php2,485 million, or 23%, to Php13,526 million substantially due to an increase in the depreciable asset base and a change in the estimated useful life of Smart's network assets owing to continuing network expansion and upgrade.

Financing costs decreased by Php457 million, or 7%, to Php6,551 million primarily due to lower interest expense on loans with lower debt balances in 2003 as compared to 2002. The breakdown of our financing costs for the wireless business for the years ended December 31, 2003 and 2002 is as follows:

| (in millions) | 2003 | 2002 | Change Amount | % |
|---|---|---|---|---|
| Accretion on financial liabilities - net | Php2,387 | Php2,082 | Php305 | 15 |
| Interest on loans and related items | 2,062 | 2,759 | (697) | (25) |
| Financing charges | 32 | 40 | (8) | (20) |
| Foreign exchange losses - net | 2,116 | 2,069 | 47 | 2 |
| Dividends on preferred stock subject to mandatory redemption | 254 | 240 | 14 | 6 |
| Capitalized foreign exchange gains (losses) | (70) | 190 | (260) | (137) |
| Loss (gain) on derivative transactions - net | 165 | (60) | 225 | 375 |
| Capitalized interest | (27) | (170) | 143 | 84 |
| Interest income | (368) | (142) | (226) | (159) |
| | Php6,551 | Php7,008 | (Php457) | (7) |

Compensation and benefits increased by Php1,090 million, or 40%, to Php3,802 million primarily due to an increase in headcount and increased salaries, benefits and performance bonuses of Smart's employees.

Selling and promotion expenses increased by Php806 million, or 32%, to Php3,310 million due to advertising and promotions costs incurred to attract new subscriptions, as well as to retain the existing subscriber base.

Asset impairment decreased by Php2,167 million, or 46%, to Php2,589 million due to impairment losses in respect of Piltel's AMPS/CDMA network assets of Php4,736 million in 2002, partially offset by impairment recognized in respect of our investment in ACeS International Limited, or AIL, and of certain equipment related to its business aggregating to Php2,589 million in 2003.

Rent expenses increased by Php252 million, or 13%, to Php2,262 million on account of an increase in the number of transmission links and higher cell site and office space rentals for the increased number of cell sites wireless centers and space requirements for increased personnel. As at December 31, 2003, we had 2,920 cell sites and 3,904 base stations, compared with 2,110 cell sites and 2,777 base stations as at December 31, 2002.

Maintenance expenses increased by Php664 million, or 48%, to Php2,051 million mainly due to higher site utility, repairs and other maintenance-related expenses associated with the expansion and upgrade of Smart's cellular network equipment; increased office and telecenter utilities expenses; and increased computer hardware and software license expense.

Taxes and licenses increased by Php602 million, or 105%, to Php1,174 million mainly due to increased business-related taxes, NTC supervision and regulation fees and disallowed input taxes.

Insurance and security services increased by Php62 million, or 9%, to Php756 million mainly due to the increase in our number of cell sites and in the amount of network equipment insured as a result of the continued growth and expansion of our network.

Professional and other service fees decreased by Php669 million, or 50%, to Php675 million mainly as a result of decreased legal, consultancy and bill collection service fees.

Provisions decreased by Php832 million, or 84%, to Php160 million due to certain subscriber and carrier accounts which have been fully provided for in 2002 coupled with lower inventory balances in 2003. The breakdown of provisions for the years ended 2003 and 2002 is as follows:

| | | | Decrease | |
|---|---|---|---|---|
| (in millions) | **2003** | **2002** | **Amount** | **%** |
| Doubtful accounts | Php72 | Php432 | (Php360) | (83) |
| Write-down of inventories at net realizable value | 88 | 560 | (472) | (84) |
| | Php160 | Php992 | (Php832) | (84) |

Other expenses increased by Php201 million, or 15%, to Php1,553 million due to various business and operational-related expenses such as facility usage fees, travel, supplies, communication and delivery expenses.

### Provision for Income Tax

Provision for income tax increased by Php1,293 million, or 360%, to Php1,652 million in 2003 from Php359 million in 2002 due to higher taxable income in 2003 as compared to 2002.

### Net Income

Our wireless business segment recorded a net income of Php9,625 million in 2003, an improvement of Php13,999 million, or 320%, over a net loss of Php4,374 million registered in 2002 due primarily to the growth in our cellular business.

## *Fixed Line*

### Revenues and Other Income

Our fixed line business provides local exchange service, international and national long distance services, data and other network services, and miscellaneous services. Revenues and other income generated from our fixed line business for 2003 totaled Php47,175 million, a decrease of Php136 million from Php47,311 million in 2003.

The following table summarizes revenues from our fixed line business for the years ended December 31, 2003 and 2002 by service segment:

| (in millions) | 2003 [1] | % | 2002 [1] | % | Increase (Decrease) Amount | % |
|---|---|---|---|---|---|---|
| Fixed line services: | | | | | | |
| Service Revenues | | | | | | |
| Local exchange | Php20,837 | 44 | Php21,382 | 45 | (Php545) | (3) |
| International long distance | 12,735 | 27 | 10,753 | 23 | 1,982 | 18 |
| National long distance | 6,561 | 14 | 7,897 | 17 | (1,336) | (17) |
| Data and other network | 5,978 | 13 | 5,479 | 11 | 499 | 9 |
| Miscellaneous | 809 | 2 | 900 | 2 | (91) | (10) |
| | 46,920 | 100 | 46,411 | 98 | 509 | 1 |
| Other Income | 255 | – | 900 | 2 | (645) | (72) |
| Total Fixed Line Revenues | Php47,175 | 100 | Php47,311 | 100 | (Php136) | – |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 - Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.

## *Service Revenues*

### *Local Exchange Service*

The following table summarizes key measures of our local exchange service business segment as at and for the years ended December 31, 2003 and 2002:

| | 2003 | 2002 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Consolidated local exchange service revenues (in millions) | Php20,837 | Php21,382 | (Php545) | (3) |
| Number of fixed lines in service | 2,185,951 | 2,188,612 | (2,661) | – |
| Number of fixed line employees | 10,518 | 12,351 | (1,833) | (15) |
| Number of fixed lines in service per employee | 208 | 177 | 31 | 18 |

Revenues from our local exchange service in 2003 decreased by Php545 million, or 3%, to Php20,837 million from Php21,382 million in 2002. The decrease was primarily due to the (1) shift in subscriber preference from postpaid to prepaid services, which generate lower average revenue per subscriber, and (2) decline in installation revenues due to a promotion starting July 2003 which waived installation cost of subscribers in an effort to stimulate subscriber growth, partially offset by adjustments in our monthly local service rates. The percentage contribution of local exchange revenues to our total fixed line revenues and other income decreased to 44% in 2003 from 45% in 2002.

Fixed line net reductions in 2003 was 2,661 as compared to a net addition of 14,530 in 2002. While fixed line additions totaled 114,277 for prepaid fixed line services, postpaid fixed lines in service declined by 116,938 in 2003. As at December 31, 2003, postpaid and prepaid fixed line subscribers totaled 1,828,647 and 357,304, respectively, which accounted for approximately 84% and 16%, respectively, of total fixed lines in service.

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. In 2003, we implemented 11 upward adjustments and three downward adjustments in our monthly local service rates, compared to 13 upward adjustments and six downward adjustments in 2002. The average peso-to-dollar rate in 2003 was Php54.215 to US$1.00, compared to the average of Php51.583 to US$1.00 in 2002. This change in the average peso-to-dollar rate translated to a peso depreciation of 5%, which resulted in an average net increase of 5% in our monthly local service rates in 2003.

### *International Long Distance Service*

The following table shows information about our international fixed line long distance business for the years ended December 31, 2003 and 2002:

| | 2003 | 2002 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Consolidated international long distance service revenues (in millions) | Php12,735 | Php10,753 | Php1,982 | 18 |
| Inbound | 10,581 | 8,461 | 2,120 | 25 |
| Outbound | 2,154 | 2,292 | (138) | (6) |
| | | | | |
| International call volumes (in million minutes, except call ratio) | 2,286 | 2,815 | (529) | (19) |
| Inbound | 2,128 | 2,644 | (516) | (20) |
| Outbound | 158 | 171 | (13) | (8) |
| Inbound-outbound call ratio | 13.5:1 | 15.5:1 | – | – |

Our consolidated international long distance service revenues increased by Php1,982 million, or 18%, to Php12,735 million in 2003 from Php10,753 million in 2002. The percentage contribution of international long distance service revenues to our total fixed line revenues and other income increased to 27% in 2003 from 23% in 2002.

Our revenues from inbound international long distance calls in 2003 increased by Php2,120 million to Php10,581 million from Php8,461 million in 2002 primarily due to an increase in PLDT's average termination rates. After lengthy negotiations commencing in May 2002 with carriers around the world, PLDT increased its termination rates with carriers that account for a substantial portion of its international inbound traffic terminating on its fixed line network to US$0.12 per minute effective February 1, 2003. Prior to the increase in termination rates, a substantial portion of PLDT's international inbound traffic terminating on its fixed line network was charged an average termination rate of approximately US$0.08 per minute. See *Note 26 – Other Matters* – (b) U.S. Federal Communications Commission, or U.S. FCC, Ruling versus Philippine Telecommunications Companies and (c) Investigation by U.S. Department of Justice to the accompanying consolidated financial statements. Our inbound international long distance call volumes in 2003 decreased by 20% to 2,128 million minutes from 2,644 million minutes in 2002, largely due to a decrease in transit calls.

Our revenues from outbound international long distance calls in 2003 decreased by Php138 million, or 6%, to Php2,154 million from Php2,292 million in 2002. The decrease resulted from higher conversion rates used as average billing rates were Php54.04 and Php51.46 in 2003 and 2002, respectively, and a change in call mix in favor of traffic utilizing least cost routes. Our outbound international long distance call volumes declined by 8% to 158 million minutes in 2003 from 171 million minutes in 2002, primarily due to cellular substitution (subscribers opting to use cellular for international outbound calls) and the popularity of alternative means of communications such as e-mailing, international text messaging and internet telephony.

***National Long Distance Service***

The following table shows our national long distance service revenues and call volumes for the years ended December 31, 2003 and 2002:

| | | | Decrease | |
|---|---|---|---|---|
| | **2003** | **2002** | **Amount** | **%** |
| Consolidated national long distance service revenues (in millions) | Php6,561 | Php7,897 | (Php1,336) | (17) |
| National long distance call volumes (in million minutes) | 2,016 | 2,181 | (165) | (8) |

Our national long distance revenues decreased by Php1,336 million, or 17%, to Php6,561 million in 2003 from Php7,897 million in 2002 as a result of lower call volumes and changes in interconnection arrangements with certain local exchange carriers. Accordingly, the percentage contribution of national long distance revenues to our total fixed line revenues and other income was down to 14% in 2003 from 17% in 2002.

Our national long distance call volumes decreased by approximately 8% to 2,016 million minutes in 2003 from 2,181 million minutes in 2002. Cellular substitution and the widespread availability and growing popularity of alternative non-voice means of communications, particularly cellular text messaging and e-mailing, have negatively affected call volumes.

The decrease in our national long distance revenues in 2003 compared to 2002 was, however, mitigated by the impact of the launch of various *PLDT Premium Phone Services* and rate adjustments. *PLDT Premium Phone Services* allow customers to access voice-based content and information through an automated call-in facility for a certain fee. Over 30 premium phone service applications are being offered to PLDT customers ranging from appointment-booking services for select embassies in the Philippines (including, among others, the U.S. and Australian embassies), entertainment and TV gameshow hotlines, televoting, spiritual and love counseling, celebrity chat, phone karaoke and music services. PLDT charges an average of Php10 per minute for these premium phone services.

In 2003, certain local exchange carriers under revenue sharing arrangements have entered into access charging agreements with PLDT. Under the revenue sharing agreements, charges are generally apportioned 30% for the originating entity, 40% for the backbone owner and another 30% for the terminating entity. Under these access charging agreements, the originating carrier generally pays access charges of (1) Php0.50 per minute for short haul traffic and Php1.25 per minute for long haul traffic to the carrier owning the backbone network, and (2) Php1.00 per minute to the terminating carrier. This change in interconnection charges resulted to an increase of 2% in average revenue per minute for calls originating from and terminating to other local exchange carriers.

Effective March 1, 2003, the rate for national long distance, or NDD, calls originating from PLDT subscribers and terminating to other local exchange carriers increased to Php5.00 per minute from a flat rate of Php4.50 per minute. In addition, NDD calls originating from and terminating to PLDT was also adjusted to Php5.00 per minute from a flat rate of Php4.50 per minute effective June 8, 2003. Prior to the implementation of a flat rate of Php5.00 per minute and Php4.50 per minute, NDD rates ranged from Php3.00 per minute to Php5.00 per minute for calls terminating to PLDT subscribers and from Php3.50 per minute to Php5.00 per minute on calls terminating to other networks' subscribers depending on distance.

***Data and Other Network Services***

In 2003, our data and other network services posted revenues of Php5,978 million, an increase of Php499 million, or 9%, from Php5,479 million in 2002. The revenue contribution of this service segment to our total fixed line revenues and other income increased to 13% in 2003 from 11% in 2002, primarily attributed to an increased uptake in *Domestic Frame Relay*, *I-Gate*, digital subscriber line, or *DSL, Equant* and *ARCSTAR* bandwidth services, as well as the launch of other new network-based services. We currently expect that demand for, and therefore revenues generated from, these services will continue to grow in the foreseeable future.

Traditional bandwidth services accounted for 50% of the total revenues from PLDT's data and other network services in 2003, broadband/IP-based services accounted for 44%, and other services accounted for the remaining 6%, compared to 57%, 38% and 5%, respectively, in 2002. These percentage changes indicate a continuing shift in data and other network revenues from traditional bandwidth services to broadband/IP-based services. We expect this trend to continue given the growing demand for broadband transmission of voice, data and video due to the continued growth of the Internet, e-commerce and other online services.

PLDT offers two residential internet service packages targeting separate markets: *PLDT Vibe* for light to medium internet users and *DSL* broadband for heavy internet users. As at December 31, 2003, the number of PLDT's fixed line subscribers for *PLDT Vibe* stood at 188,034, of which 110,502 were exclusive postpaid users, 58,939 were exclusive prepaid users, and 18,593 were both postpaid and prepaid users, compared to 73,275 as at December 31, 2002, of which 58,139 were exclusive postpaid users, 12,397 were exclusive prepaid users, and 2,739 were both postpaid and prepaid users, while the number of *DSL* subscribers reached 23,884 and 10,896 as at December 31, 2003 and 2002, respectively.

In March 2003, PLDT launched a number of data services, namely: *Continuum, iView* and *Encompass*, all under the *Brains* umbrella. *Brains Continuum* provides customers the ability to recover from service interruptions and offers network diversity, facility and hosting services in partnership with ePLDT. *Brains iView* enables customers to monitor the performance of their network, track bandwidth utilization patterns and identify the source of network problems. *Brains Encompass* provides a broad range of services for the customers' managed networking needs, be it a wide area network or local area network.

In April 2003, PLDT introduced *Resort Solutions,* a network service that provides communication links between the head office and the remote offices of vacation resorts. It enables resort offices to access the information vital to the business and to do transactions such as real-time updating of room bookings, real-time checking of room inventory or even real-time audit of resort profitability via IP-VPN or Internet access.

In May 2003, *Shops.work* was fully launched, a network service that allows the electronic linking of retail stores providing, among other features, sales and inventory reports, up-to-date and real-time monitoring of sales and inventory, and on-line access to head offices.

In June 2003, *Embed* was introduced to the market through a soft launch. The service is a wholesale banking solution that enables a bank partner to build a community among its clients in a business to business or business to consumer arrangement through the use of IP-VPN network solution.

In September 2003, *High Bandwidth Optical Service*, or *HBOS,* was launched, a dedicated high-speed point-to-point optical access solution that enables data mirroring, storage area network, or SAN, and local area network, or LAN, interconnectivity within Metro Manila. *HBOS* offers an option for a virtually ready alternative data center.

***Miscellaneous***

Miscellaneous revenues are derived mostly from directory advertising and facilities rental. In 2003, these revenues decreased by Php91 million, or 10%, to Php809 million from Php900 million in 2002, and accounted for approximately 2% of our total fixed line revenues and other income in each of these comparable periods.

### *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 2003, our fixed line business segment registered a decrease in other income of Php645 million, or 72%, to Php255 million in 2003 from Php900 million in 2002 mainly due to a net gain of Php633 million relating to certain financial instruments terminated in 2002.

### Expenses

Expenses related to our fixed line business in 2003 totaled Php56,315 million, a decrease of Php1,785 million, or 3%, compared to Php58,100 million in 2002. The decrease was primarily due to lower asset impairment, and depreciation and amortization. As a percentage of our total fixed line revenues, fixed line-related expenses decreased to 119% in 2003, compared to 123% in 2002.

The following table shows the breakdown of our total consolidated fixed line-related expenses for the years ended December 31, 2003 and 2002 and the percentage of each expense item to the total:

| (in millions) | 2003[1] | % | 2002[1] | % | Increase (Decrease) Amount | % |
|---|---|---|---|---|---|---|
| Fixed line services: | | | | | | |
| Financing costs | Php18,782 | 34 | Php14,758 | 25 | Php4,024 | 27 |
| Compensation and benefits[2] | 10,507 | 19 | 7,965 | 14 | 2,542 | 32 |
| Depreciation and amortization | 9,767 | 17 | 10,623 | 18 | (856) | (8) |
| Provisions | 4,597 | 8 | 3,659 | 6 | 938 | 26 |
| Maintenance | 3,081 | 6 | 2,911 | 5 | 170 | 6 |
| Asset impairment | 2,846 | 5 | 11,957 | 21 | (9,111) | (76) |
| Rent | 1,915 | 3 | 1,829 | 3 | 86 | 5 |
| Professional and other service fees | 1,129 | 2 | 1,092 | 2 | 37 | 3 |
| Selling and promotions | 1,054 | 2 | 1,077 | 2 | (23) | (2) |
| Insurance and security services | 762 | 1 | 655 | 1 | 107 | 16 |
| Taxes and licenses | 595 | 1 | 507 | 1 | 88 | 17 |
| Other expenses | 1,280 | 2 | 1,067 | 2 | 213 | 20 |
| Total | Php56,315 | 100 | Php58,100 | 100 | (Php1,785) | (3) |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 – Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Includes salaries and benefits, incentive plan, pension and MRP costs.

Financing costs increased by Php4,024 million, or 27%, to Php18,782 million due to higher foreign exchange losses pertaining to the foreign exchange revaluation of the carrying values of financial liabilities as the level of peso depreciation was higher in 2003 as compared to 2002, partially offset by lower interest expense and related items owing to lower debt balances in 2003 as compared to 2002. The breakdown of our financing costs for our fixed line business for the years ended December 31, 2003 and 2002 is as follows:

| (in millions) | 2003 | 2002 | Increase (Decrease) Amount | % |
|---|---|---|---|---|
| Interest on loans and related items | Php10,894 | Php11,989 | (Php1,095) | (9) |
| Hedge cost | 1,054 | 315 | 739 | 235 |
| Financing charges | 232 | 203 | 29 | 14 |
| Foreign exchange losses - net | 7,235 | 3,901 | 3,334 | 85 |
| Accretion on financial liabilities - net | 280 | 242 | 38 | 16 |
| Capitalized foreign exchange losses | (275) | (152) | (123) | (81) |
| Loss (gain) on derivative transactions - net | 360 | (487) | 847 | 174 |
| Capitalized interest | (860) | (1,173) | 313 | 27 |
| Interest income | (138) | (80) | (58) | (73) |
| | Php18,782 | Php14,758 | Php4,024 | 27 |

Compensation and benefits increased by Php2,542 million, or 32%, to Php10,507 million mainly due to a collective bargaining agreement-related increases in salaries and benefits of PLDT employees and PLDT's MRP, where MRP cost of Php1,890 million was recognized in 2003 as compared to MRP cost of Php324 million in 2002. See *Note 5 – Revenues and Expenses* to the accompanying consolidated financial statements for further discussion on PLDT's MRP.

Depreciation and amortization charges decreased by Php856 million, or 8%, to Php9,767 million mainly due to lower depreciation of our regular asset base primarily resulting from asset disposals.

Provisions increased by Php938 million, or 26%, to Php4,597 million primarily on account of higher provisions by PLDT for anticipated uncollectible accounts from various specifically identified domestic telecommunications carriers. In addition, write-down of inventories at net realizable value relating to the slow moving spare parts and provison for onerous contracts in respect of ATPA Agreement with AIL were recognized in 2003. Please see *Note 21 – Related Party Transactions* and *Note 24 – Provisions and Contingencies* in the accompanying consolidated financial statements. The breakdown of provisions for our fixed line business for the years ended 2003 and 2002 is as follows:

| (in millions) | 2003 | 2002 | Increase Amount | % |
|---|---|---|---|---|
| Doubtful accounts | Php3,949 | Php3,659 | Php290 | 8 |
| Write-down of inventories at net realizable value | 238 | – | 238 | 100 |
| Onerous contracts | 410 | – | 410 | 100 |
| | Php4,597 | Php3,659 | Php938 | 26 |

Maintenance expenses increased by Php170 million, or 6%, to Php3,081 million primarily due to higher maintenance costs of inside plant facility, computer and peripherals and submarine cable in 2003 as compared to 2002, partially offset by lower maintenance costs on outside plant facilities.

Rent expenses increased by Php86 million, or 5%, to Php1,915 million due to higher rentals paid by PLDT to suppliers of customer premises equipment as part of its bundled services to corporate customers, partially offset by reduced number of leased transponders.

Asset impairment decreased by Php9,111 million, or 76%, to Php2,846 million due to the recognition of impairment losses of Php11,957 million relating to Piltel's E.O. 109 assets in 2002, partially offset by additional impairment of Piltel's E.O. 109 facilities amounting to Php1,438 million and impairment of an unrealizable asset of Php1,408 million in 2003.

Professional and other service fees increased by Php37 million, or 3%, to Php1,129 million as a result of higher legal fees in 2003 for various services, partially offset by a decrease in number of consultants in line with PLDT's cost management efforts.

Selling and promotion expenses decreased by Php23 million, or 2%, to Php1,054 million mainly due to a reduced marketing and corporate public relations expenses as part of our cost reduction initiatives.

Insurance and security services increased by Php107 million, or 16%, to Php762 million primarily due to higher premiums on property all-risks insurance for properties, and directors' and officers' liability insurance for 2003 as compared to 2002.

Taxes and licenses increased by Php88 million, or 17%, to Php595 million mainly on account of higher business-related taxes paid in 2003 as compared to 2002.

Other expenses increased by Php213 million, or 20%, to Php1,280 million due to higher contracted costs for technical and helpdesk resources and related computer and maintenance and in-house systems development, partially offset by lower office supplies consumption and printing costs resulting from PLDT's continuing cost-containing activities.

### Provision for (Benefit from) Income Tax

Benefit from income tax amounted to Php2,130 million in 2003 as compared to a provision for income tax of Php530 million in 2002 due to a tax loss position in 2003 as non-tax deductible charges were higher in 2003.

### Net Loss

In 2003, our fixed line business segment contributed a net loss of Php7,118 million, compared to a net loss of Php11,377 million in 2002 mainly as a result of a decrease in fixed line-related expenses, particularly asset impairment charges coupled with a tax benefit from income tax of Php2,130 million in 2003.

## *Information and Communications Technology*

### Revenues and Other Income

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

In 2003, our information and communications technology business generated revenues of Php1,893 million, an increase of Php879 million, or 87%, from Php1,014 million in 2002. Going forward, we expect revenues from our call center and Internet and gaming businesses to continue to contribute significantly to our information and communications technology revenues with the growing demand for call center services.

The following table summarizes revenues from our information and communications technology business for the years ended December 31, 2003 and 2002 by service segment:

| | | | | | Increase | |
|---|---|---|---|---|---|---|
| (in millions) | **2003** | % | **2002** | % | **Amount** | % |
| Service Revenues | | | | | | |
| Call center | Php927 | 49 | Php305 | 30 | Php622 | 204 |
| Internet and gaming | 380 | 20 | 375 | 37 | 5 | 1 |
| *Vitro*™ data center | 120 | 6 | 89 | 9 | 31 | 35 |
| Others | 40 | 2 | 4 | – | 36 | 900 |
| | 1,467 | 77 | 773 | 76 | 694 | 90 |
| Non-service Revenues | | | | | | |
| Point of product sales | 316 | 17 | 205 | 20 | 111 | 54 |
| Other Income | 110 | 6 | 36 | 4 | 74 | 206 |
| Total ICT Revenues | Php1,893 | 100 | Php1,014 | 100 | Php879 | 87 |

### *Service Revenues*

Service revenues generated by our information and communications technology business amounted to Php1,467 million in 2003, an increase of Php694 million, or 90%, from Php773 million in 2002 primarily a result of the continued growth of our call center businesses.

#### *Call Center*

Revenues related to our call center business in 2003 increased by Php622 million, or 204%, to Php927 million from Php305 million in 2002 due to the commencement of commercial operations of Vocativ and Parlance in April and June 2002, respectively, which contributed incremental revenues for the year ended December 31, 2003 amounting to Php249 million and Php232 million, respectively. Call center revenues accounted for 49% and 30% of our total information and communications technology revenues in 2003 and 2002, respectively.

#### *Internet and Gaming*

Revenues from our internet and gaming business for 2003 increased by Php5 million, or 1%, to Php380 million from Php375 million in 2002 primarily due to an increase in prepaid card revenues coupled with an increase in subscriber base of Infocom partially offset by lower ARPU in 2003. Our internet and gaming business revenues accounted for 20% and 37% of total revenues from information and communications technology business in 2003 and 2002, respectively.

#### *Vitro™ Data Center*

In 2003, *Vitro*™ contributed revenues of Php120 million, an increase of Php31 million, or 35%, from Php89 million in 2002, primarily due to an increase in co-location revenues, server hosting and other services. *Vitro*™ revenues accounted for 6% and 9% of total revenues from information and communications technology business in 2003 and 2002, respectively.

#### *Others*

Revenues from other businesses related to our information and communications technology segment in 2003 increased by Php36 million, or 900%, to Php40 million from Php4 million in 2002 largely due to IT helpdesk/contact center services rendered coupled with an increase in number of digital certificates sold, and commencement of operations of iPlus in February 2003 which generated revenues of Php32 million.

### *Non-service Revenues*

Non-service revenues consist of sales generated from resellership of Microsoft software licenses and Cisco hardware equipment. In 2003, non-service revenues generated by our information and communications technology business increased by Php111 million, or 54%, to Php316 million prompted by higher point of product sales of Cisco equipment and Microsoft licenses.

### *Other Income*

All other income/gains which do not fall under service and non-service revenues are included under this classification. Other income generated from our information and communications technology business segment increased by 206% to Php110 million in 2003 from Php36 million in 2002 due to a gain on the divestment of Contact World, Inc., a call center facility, in 2003.

### Expenses

Expenses associated with our information and communications technology business totaled Php2,354 million in 2003, an increase of Php682 million, or 41%, from Php1,672 million in 2002. As a percentage of our information and communications technology revenues, expenses related to our information and communications technology business was at 124% and 165% for 2003 and 2002, respectively.

The following table shows the breakdown of our total consolidated information and communications technology-related expenses for the years ended December 31, 2003 and 2002 and the percentage of each expense item to the total:

| (in millions) | 2003[1] | % | 2002[1] | % | Increase (Decrease) Amount | % |
|---|---|---|---|---|---|---|
| Information and communications technology services: | | | | | | |
| Compensation and benefits[2] | Php551 | 23 | Php349 | 21 | Php202 | 58 |
| Asset impairment | 387 | 16 | – | – | 387 | 100 |
| Rent | 339 | 14 | 270 | 16 | 69 | 26 |
| Depreciation and amortization | 313 | 13 | 418 | 25 | (105) | (25) |
| Maintenance | 184 | 8 | 200 | 12 | (16) | (8) |
| Provisions | 82 | 4 | 45 | 3 | 37 | 82 |
| Professional and other service fees | 65 | 3 | 89 | 5 | (24) | (27) |
| Financing costs | 53 | 2 | – | – | 53 | 100 |
| Selling and promotions | 35 | 2 | 66 | 4 | (31) | (47) |
| Taxes and licenses | 18 | 1 | 6 | – | 12 | 200 |
| Insurance and security services | 10 | – | 5 | – | 5 | 100 |
| Other expenses | 317 | 14 | 224 | 14 | 93 | 42 |
| Total | Php2,354 | 100 | Php1,672 | 100 | Php682 | 41 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 – Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Includes salaries and benefits, incentive plan, pension and MRP costs.

Compensation and benefits increased by Php202 million, or 58%, to Php551 million mainly due to the expansion of our call center facilities which resulted in a 46% increase in headcount coupled with an increase in salaries, bonuses and various incentives of employees.

Asset impairment increased to Php387 million due to the retirement of certain equipment primarily as a result of the abandonment of a reloadable chip-based cash card project in 2003.

Rent expense increased by Php69 million, or 26%, to Php339 million due to the opening of several *Netopia* internet café branches countrywide and abroad.

Depreciation and amortization charges decreased by Php105 million, or 25%, to Php313 million primarily due to the write-off of Sidera's fixed assets amounting to Php203 million in 2003.

Maintenance expenses decreased by Php16 million, or 8%, to Php184 million primarily due to the expiration of warranty of certain assets of *Vitro*™ maintained by ePLDT.

Provisions increased by Php37 million, or 82%, owing to specifically identified uncollectible subscriber accounts of Infocom provided for in 2003.

Professional and other service fees decreased by Php24 million, or 27%, to Php65 million primarily due to lower fees paid by Contact World for training and consultancy services rendered by Dell Corp. in relation to its expansion prior to its divestment in June 2003.

Financing costs increased to Php53 million due to higher interest expense on loans as debt balances increased coupled with lower interest income in 2003 as compared to 2002.

Selling and promotion expenses decreased by Php31 million, or 47%, to Php35 million mainly due to the intensified marketing activities of Infocom, particularly audio video conferencing, in 2002.

Taxes and licenses increased by Php12 million, or 200%, to Php18 million mainly on account of higher business-related taxes paid in 2003 as compared to 2002.

Insurance and security services increased by Php5 million, or 100%, to Php10 million primarily due to the additional insurance premium of Parlance and Vocativ for additional capital expenditures in 2003. Security expense of Parlance and Vocativ also increased due to their full year operations in 2003.

Other expenses increased by Php93 million, or 42%, to Php317 million mainly due to the increase in various business-related expenses associated with the continuous expansion, and other miscellaneous expenses incurred by call center projects started in 2003.

### Provision for (Benefit from) Income Tax

Benefit from income tax amounted to Php67 million in 2003, an increase of Php66 million as compared to the benefit from income tax of Php1 million recognized in 2002. This was principally due to deferred income tax provision recognized by Infocom in 2003.

### Net Loss

In 2003, our information and communications technology business segment registered a net loss of Php384 million, an improvement of Php218 million, or 36%, compared to a net loss of Php602 million posted in 2002. This reflects the recorded increase in net income contribution of our call center business, partially offset by a net increase in asset impairment charges.

## Liquidity and Capital Resources

The following table shows our consolidated cash flows for the years ended December 31, 2004, 2003 and 2002 as well as consolidated capitalization and other selected financial data as at December 31, 2004, 2003 and 2002:

| (in millions) | 2004 | 2003 [1] | 2002 [1] |
|---|---|---|---|
| **Cash Flows** | | | |
| Net cash provided by operating activities | Php73,514 | Php55,972 | Php54,638 |
| Net cash used in investing activities | 23,939 | 19,610 | 17,202 |
| Capital expenditures | 21,162 | 18,019 | 16,904 |
| Net cash used in financing activities | 41,557 | 27,937 | 30,827 |
| Net increase in cash and cash equivalents | 7,949 | 8,397 | 6,699 |

| (in millions) | 2004 | 2003 [1] |
|---|---|---|
| **Capitalization** | | |
| Interest-bearing financial liabilities: | | |
| Long-term financial liabilities: | | |
| Long-term debt | Php121,012 | Php152,646 |
| Obligations under capital lease | 601 | 729 |
| Preferred stock subject to mandatory redemption | 14,375 | 12,735 |
| | 135,988 | 166,110 |
| Interest-bearing financial liabilities maturing within one year: | | |
| Notes payable | 58 | 2,133 |
| Obligations under capital lease maturing within one year | 425 | 295 |
| Long-term debt maturing within one year | 28,018 | 23,810 |
| | 28,501 | 26,238 |
| Total interest-bearing financial liabilities | 164,489 | 192,348 |
| Total equity | 48,515 | 21,449 |
| | Php213,004 | Php213,797 |
| **Other Financial Data** | | |
| Total assets | Php265,473 | Php255,647 |
| Property, plant and equipment-net | 194,525 | 194,790 |
| Cash and cash equivalents | 27,321 | 19,372 |

[1] As restated to reflect the effects of the changes in accounting policies, as discussed in *Note 2 – Summary of Significant Accounting Policies* to the accompanying consolidated financial statements.
[2] Includes salaries and benefits, incentive plan, pension and MRP costs.

As at December 31, 2004, our consolidated cash and cash equivalents totaled Php27,321 million. Principal sources of consolidated cash and cash equivalents in 2004 were cash flows from operations amounting to Php73,514 million and drawings from long-term and short-term credit facilities aggregating Php12,131 million and Php457 million, respectively, and equity funds raised through the issuance of capital stock amounting to Php281million. These funds were used principally for capital outlays of Php21,162 million, (including capitalized interest of Php595 million), total debt principal payments of Php41,960 million and interest payments of Php12,310 million.

Principal sources of consolidated cash in 2003 and 2002 were cash flows from operations amounting to Php55,972 million and Php54,638 million, respectively; drawings from long-term and short-term credit facilities totaling Php15,361 million and Php3,135 million, respectively, in 2003, and Php32,566 million and Php8,058 million, respectively, in 2002; and equity funds raised through the issuance of capital stock amounting to Php95 million in 2003. These funds were used principally for capital outlays of Php18,019 million (including capitalized interest of Php887 million), payments of long-term and short-term debt totaling Php32,728 million and interest payments of Php12,647 million in 2003; and capital outlays of Php16,904 million, (including capitalized interest of Php1,343 million), payments of long-term and short-term debt totaling Php52,318 million, interest payments of Php14,527 million and equity funds raised through the issuance of capital stock amounting to Php464 million in 2002.

### *Operating Activities*

Our consolidated net cash flows from operating activities in 2004 increased by Php17,542 million, or 31%, to Php73,514 million from Php55,972 million in 2003 and by Php1,334 million, or 2%, from Php54,638 million in 2002.

A growing portion of our consolidated cash flows is generated by our wireless business, which accounted for 61% of our consolidated revenues and other income in 2004, compared to 57% in 2003 and 51% in 2002. Revenues from our fixed line and information and communications technology services accounted for 37% and 2%, respectively, of our consolidated revenues and other income in 2004, compared to 41% and 2%, respectively, in 2003 and 48% and 1%, respectively, in 2002.

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

While Smart is subject to loan covenants that restrict its ability to pay dividends, redeem preferred shares, make distributions to PLDT or otherwise provide funds to PLDT or any associate without the consent of its lenders, Smart has been able to obtain waivers from Finnvera and certain of its lenders for each of the dividend payments made by Smart to PLDT in 2004, 2003 and 2002. In 2004, Smart paid an aggregate of Php16,100 million in dividends to PLDT, of which Php11,280 million was paid in May 2004 and the balance of Php4,820 million paid in December 2004. In June and November 2003, Smart paid dividends in the amount of Php4,300 million and Php1,866 million, respectively. Smart made its first dividend payment of Php1,540 million to PLDT in December 2002.

### *Investing Activities*

Our net cash used in investing activities in 2004 amounted to Php23,939 million, an increase of Php4,329 million, or 22%, compared to Php19,610 million in 2003 and by Php2,408 million, or 14%, from Php17,202 million in 2002. This increase was primarily the result of higher aggregate capital spending.

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

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

Our net cash used in investing activities increased by Php2,408 million, or 12%, in 2003 to Php19,610 million from Php17,202 million in 2002 due to higher capital spending. The increase in our consolidated capital expenditures in 2003 of Php1,115 million, or 7%, was largely attributable to PLDT and Smart. PLDT's capital outlay was principally used to finance the continued build-out of its data and broadband/IP infrastructure and investment in Asia Pacific Cable Network 2 while Smart's capital spending was principally used to finance the expansion of its GSM and transmission facilities due to the increasing number of its subscriber base and network coverage.

### *Financing Activities*

On a consolidated basis, we used net cash of Php41,557 million for financing activities in 2004, compared to Php27,937 million in 2003 and Php30,827 million in 2002. The net cash used in financing activities in 2004, 2003 and 2002 was mainly attributable to interest payments and debt repayments by PLDT in line with its ongoing debt reduction program.

#### *Debt Financing*

Additions to our consolidated long-term debt in 2004 totaled Php12,131 million, of which Php8,104 million came from Smart's drawings, principally from its Phase 5 GSM loan facilities and Php3,976 million came from PLDT's drawings, primarily from long-term loan facilities used to finance capital expenditures and refinancing facilities used to repay maturing debts. Payments in respect of principal and interest of our total debt amounted to Php41,960 million and Php12,310 million, respectively, in 2004, of which Php32,518 million and Php10,539 million were attributable to PLDT, respectively.

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

| | | | Increase (Decrease) | |
|---|---|---|---|---|
| (in millions) | 2004 | 2003 | Amount | % |
| | | (As restated - Note 2) | | |
| U.S. Dollars: | | | | |
| Export Credit Agencies-Supported Loans | Php41,266 | Php50,504 | (Php9,238) | (18) |
| Fixed Rate Notes | 68,795 | 77,880 | (9,085) | (12) |
| Term Loans | 20,492 | 11,079 | 9,413 | 85 |
| Restructured Loans | 4,815 | 7,310 | (2,495) | (34) |
| Satellite Acquisition Loans | 4,064 | 4,722 | (658) | (14) |
| | 139,432 | 151,495 | (12,063) | (8) |
| Japanese Yen: | | | | |
| Overseas Investment Loan | 5,363 | 5,068 | 295 | 6 |
| Export Credit Agency-Supported Loan | 1,212 | – | 1,212 | 100 |
| Multi-currency Term Loan | – | 5,487 | (5,487) | (100) |
| Restructured Loans | – | 6,963 | (6,963) | (100) |
| | 6,575 | 17,518 | (10,943) | (62) |
| Philippine Pesos: | | | | |
| Peso Fixed Rate Corporate Notes | 1,675 | 2,173 | (498) | (23) |
| Term Loans | 1,348 | 5,270 | (3,922) | (74) |
| | 3,023 | 7,443 | (4,420) | (59) |
| | Php149,030 | Php176,456 | (Php27,426) | (16) |

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

Our long-term debt decreased by Php27,426 million, or 16%, to Php149,030 million as at December 31, 2004 largely due to debt repayments in line with PLDT's efforts to reduce overall debt level. PLDT's long-term debt was reduced by 18% to Php110,077 million by the end of 2004. On the other hand, Smart's indebtedness increased by 50% to Php29,355 million at the end of 2004 on account of the debt exchange transaction with Piltel's creditors in July 2004 where Smart issued new debt of US$283.3 million booked at fair value of Php8,390 million, net of debt discount amounting to Php7,464 million; Smart's unamortized discount amounted to Php7,239 million as at December 31, 2004. Similarly, Piltel's debt balance owed to third parties as at December 31, 2004 was reduced to Php5,230 million, net of unamortized discount of Php2,006 million. Mabuhay Satellite's debt level decreased by 14% to Php4,064 million owing to debt amortizations during the year. Other subsidiaries' indebtedness increased by Php173 million primarily from Vocativ's full availment of a 5-year Php149 million term loan facility.

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

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

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

[1] The exchange rate used was Php56.341 to US$1.00.

[2] The exchange rate used was Php0.5495 to JP¥1.00.

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

Please see *Note 18 – Interest-bearing Financial Liabilities* to the accompanying 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 intend to restore the payment of common dividends in 2005 and gradually increase our dividend payout ratio in succeeding years as we improve our leverage ratios.

***Credit Ratings***

None of our existing indebtedness contains provisions under which credit rating downgrades would trigger a default, changes in applicable interest rates or other similar terms and conditions.

On April 1, 2005, Fitch Ratings has positioned PLDT's "BB" long-term local currency rating on Rating Watch Positive. Simultaneously, Fitch has affirmed PLDT's long-term foreign currency rating, global bonds and senior notes at "BB" and PLDT's convertible preferred stock at "B+". The outlook on the affirmed ratings remains negative, reflecting the outlook of the Republic of the Philippines' long-term foreign currency rating. However, PLDT's local currency rating is not constrained by the negative outlook on the sovereign's local currency rating. The decision to place PLDT's long-term foreign currency rating on Rating Watch Positive recognizes PLDT's stable operating performance and consistent improvement in financial profile over a sustained period.

On February 16, 2005, Moody's Investor Service, or Moody's, downgraded the foreign currency senior unsecured debt rating of PLDT by one-notch to Ba3 from Ba2 with a stable outlook. The rating action was taken as part of Moody's two-notch downgrade of the Republic of the Philippines' foreign currency country ceiling to B1 from Ba2. On the same date, Moody's affirmed PLDT's B1 preferred stock rating with a stable outlook. Moody's views that there is a differential between PLDT's foreign currency rating and the sovereign

rating. According to Moody's, PLDT's foreign currency bond rating is a function of its own risk of default and is less likely to be subject to a debt moratorium which the Philippine government may declare in case of an event of default by government.

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

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

***Equity Financing***

PLDT raised Php281 million from the exercise by certain officers and executives of stock options in 2004. In addition, through our subscriber investment plan, or SIP, which provides postpaid fixed line subscribers the opportunity to buy shares of our 10% cumulative convertible preferred stock as part of the upfront payments collected from subscribers, PLDT was able to raise Php5 million in 2004 and Php95 million in 2003. As approved by the NTC, the SIP was made optional in 2003 from being compulsory in earlier years.

Cash dividend payments in 2004 amounted to Php1,456 million, compared to Php1,349 million in 2003, and Php1,341 million in 2002, all of which were paid to preferred shareholders of PLDT. The most recent cash dividend paid by PLDT to its common shareholders was in April 2001 (dividends declared in March 2001); since then, no dividends have been paid to common shareholders. We intend to restore the payment of dividends to common shareholders in 2005.

As of February 28, 2005, there were 14,036 holders of record of PLDT's common shares. High and low sales prices for PLDT's common shares on the Philippine Stock Exchange and ADSs on the New York Stock Exchange for each of the full quarterly periods during 2004 and 2003 and for the first three months of 2005 were as follows:

| | Philippine Stock Exchange | | New York Stock Exchange | |
|---|---|---|---|---|
| | High | Low | High | Low |
| 2005 | | | | |
| January | Php1,460.00 | Php1,310.00 | US$26.34 | US$23.50 |
| February | 1,440.00 | 1,350.00 | 26.45 | 24.64 |
| March | 1,495.00 | 1,350.00 | 27.75 | 25.05 |
| 2004 | | | | |
| First Quarter | Php1,050.00 | Php810.00 | US$18.60 | US$14.38 |
| Second Quarter | 1,165.00 | 960.00 | 21.20 | 16.97 |
| Third Quarter | 1,450.00 | 1,150.00 | 25.72 | 20.90 |
| Fourth Quarter | 1,505.00 | 1,215.00 | 27.03 | 21.83 |
| 2003 | | | | |
| First Quarter | Php 337.50 | Php 265.00 | US$6.18 | US$4.85 |
| Second Quarter | 565.00 | 312.50 | 11.15 | 5.80 |
| Third Quarter | 670.00 | 482.50 | 12.48 | 8.78 |
| Fourth Quarter | 990.00 | 635.00 | 17.79 | 11.70 |

### *Contractual Obligations and Commercial Commitments*

Please refer to *Note 23 - Contractual Obligations and Commercial Commitments* to the accompanying consolidated financial statements.

### Quantitative and Qualitative Disclosures about Market Risks

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

***Liquidity Risk Management***

We seek to manage our liquidity profile to be able to finance our capital expenditures and service our maturing debts. To cover our financing requirements, we intend to use internally generated funds and proceeds from debt and equity issues and sales of certain assets.

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

***Foreign Exchange Risk Management***

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

million, as compared to Php345 million in 2003. These capitalized net foreign exchange losses which qualified as borrowing costs were attributable to foreign currency-denominated liabilities used to finance our capital investments and were therefore recorded as additions to the carrying value of the related property accounts.

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

As at December 31, 2004, approximately 98% of our total consolidated debts were denominated in foreign currencies. Of our foreign currency-denominated debts, 4% are in Japanese yen on a consolidated basis and the balance in U.S. dollars. Thus, a weakening of the peso against the U.S. dollar or Japanese yen will increase both the principal amount of our unhedged foreign currency-denominated debts (representing 64% of our consolidated foreign-currency debts), and interest expense on our debt in peso terms. In addition, many of our financial ratios and other financial tests will be negatively affected. If, among other things, the value of the peso against the U.S. dollar substantially drops from its current level, we may be unable to maintain compliance with these ratios, which could result in acceleration of some or all of our indebtedness. For further information on our loan covenants, see "Liquidity and Capital Resources — Financing Activities — Covenants" above and *Note 18 – Interest-bearing Financial Liabilities* to the accompanying consolidated financial statements.

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

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

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

***Interest Rate Risk Management***

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

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

### Effect of Peso Depreciation

In 2004 and 2003, our service revenues, which have been received in U.S. dollars or in respect of which we have been able to adjust our service fees to reflect changes in the peso-to-dollar exchange rate exceeded our U.S. dollar-linked business expenses.

However, since substantially all of our indebtedness is denominated in U.S. dollars, such depreciation has also increased our interest expense in peso terms and increased our recognition of foreign exchange losses as we revalue our U.S. dollar-denominated indebtedness. Our cash flows are negatively affected by the higher peso cost of repaying U.S. dollar-denominated debts, and our ability to comply with financial covenants and ratios is negatively affected by the increase in the amount of our debts and our interest expenses in peso terms.

### Impact of Inflation and Changing Prices

Inflation can be a significant factor in the Philippine economy, and we are continually seeking ways to minimize its impact. In recent periods, while decreases in the relative value of the peso have had a significant effect on us, we do not believe inflation has had a material impact on our operations. The average inflation rate in the Philippines in 2004 was 6.0%, compared to 3.1% in 2003.

### Other Information

#### *Changes in Management Agreements between Piltel and Smart*

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

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

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

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

***Piltel Debt Exchange Transaction***

On July 2, 2004, Smart closed the Piltel debt exchange transaction. Approximately US$289 million, or 69.4%, in the aggregate of the outstanding restructured Piltel debt were exchanged by Piltel creditors for cash and Smart debt. Smart paid cash of US$1.5 million (Php84 million) and issued new debt of US$283.3 million at fair value of Php8,390 million, net of debt discount amounting to Php7,464 million. The breakdown of the total amount of Smart debt issued to participating Piltel creditors are as follows:

- 2007 Facility for US$0.2 million payable in full in December 2007;
- 2008 Facility for US$2.9 million payable in full in December 2008; and
- 2014 Facility for US$280.1 million payable in full in June 2014.

Interest for the above facilities are payable every quarter at a floating rate of three months US$ LIBOR + 1.00% for the 2007 and 2008 facilities, and a fixed rate of 2.25% per annum for the 2014 facility. Furthermore, a portion of the 2014 facility amounting to US$144 million has a variable yield option whereby the creditor has an option to elect for an early repayment at a discount either in December 2007 at 52.5% of the relevant debt amount or in December 2008 at 57.5% of the relevant debt amount.

Further, on July 2, 2004, to integrate our wireless holdings, Smart entered into a Sale and Purchase Agreement with PLDT to acquire the latter's 59.3 million shares of Piltel Series K, Class I Convertible Preferred Stock for Php2,066 million. The payment was settled through an offset of amounts owed to Smart by PLDT arising primarily from interconnection charges.

On July 9, 2004, Smart converted a total of 4.8 million shares of Piltel Series K, Class I Convertible Preferred Stock into 820.3 million shares of Piltel common stock, equivalent to 32.7% of the total outstanding shares of common stock of Piltel after such conversion. Such initial conversion resulted in diluting PLDT's ownership in Piltel from 45.3%to 30.5%. Smart intends to convert its remaining 54.5 million shares of Piltel Series K, Class I Convertible Preferred Stock into 9,260 million shares of common stock from the increase in authorized capital stock of Piltel. On September 3, 2004, at a special stockholders' meeting, Piltel's stockholders approved an increase in Piltel's authorized capital stock from 2,700 million shares of common stock to 11,800 million shares of common stock. The approved increase enables Piltel to accommodate the full conversion of the Series K, Class I Convertible Preferred Stock. Such conversion is expected to take place once all the necessary regulatory approvals have been obtained and is likely to be completed before the end of the year. Once all the outstanding shares of Piltel Series K, Class I Convertible Preferred Stock are fully converted, Smart will hold a total of 10,080 million shares of common stock of Piltel, equivalent to 85.6% of the resulting total outstanding shares of common stock after such conversion. In aggregate therefore, upon completion of the conversion, ownership of Piltel by PLDT and Smart will be 92.1%. Transactions of entities under common control were accounted for under historical cost.

***Acquisition of Meridian Telekoms, Inc.***

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

***PLDT CBA Negotiations Concluded with a MOA***

On March 8, 2005, PLDT and PLDT Sales Supervisors' Union, or PSSU, concluded and signed a new three-year CBA covering the period from January 1, 2005 to January 1, 2007. Effectivity date has been negotiated to be moved from March to January. Likewise, on January 20, 2005, PLDT and *Gabay ng Unyon sa Telekomunikasyon ng mga Superbisor*, or GUTS, our supervisors' union, concluded and signed a new three-year CBA covering the period from January 1, 2005 to January 1, 2007.

## Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

We have no disagreements with our external auditor on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure.

# STATEMENT OF MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

March 1, 2005

We are responsible for all information and representations contained in the consolidated financial statements of Philippine Long Distance Telephone Company as at December 31, 2004 and 2003 and for each of the three years in the period ended December 31, 2004. Our consolidated financial statements were prepared in conformity with generally accepted accounting principles in the Philippines and reflect amounts that are based on our best estimates and informed judgment with an appropriate consideration to materiality.

In this regard, we maintain a system of accounting and reporting which provides for the necessary internal controls to ensure that transactions are properly authorized and recorded, assets are safeguarded against unauthorized use or disposition and liabilities are recognized. We likewise disclose to our Audit Committee and our independent auditors: (i) all significant deficiencies in the design or operation of internal controls that could adversely affect our ability to record, process, and report financial data; (ii) material weaknesses in our internal controls; and (iii) any fraud that involves management or other employees who exercise significant roles in internal controls.

Our Board of Directors reviews our financial statements before these statements are approved and submitted to our Stockholders.

SyCip Gorres Velayo & Co., a member practice of the Ernst & Young Global, the independent auditors appointed by our Stockholders, have audited our consolidated financial statements as at December 31, 2004 and 2003, and for each of the three years in the period ended December 31, 2004 in accordance with generally accepted auditing standards in the Philippines and have expressed their opinion on the fairness of presentation upon completion of such audit, in their report to our Stockholders and our Board of Directors dated March 1, 2005.

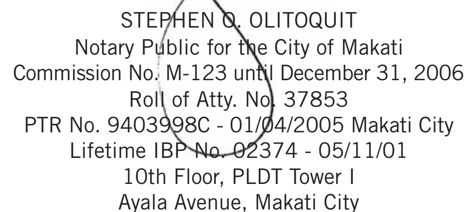
MANUEL V. PANGILINAN
*Chairman of the Board*

NAPOLEON L. NAZARENO
*President and Chief Executive Officer*

ANABELLE L. CHUA
*Senior Vice President and Treasurer*

SUBSCRIBED AND SWORN to before me this 11th day of April 2005 affiants exhibiting to me their Community Tax Certificates (CTCs), as follows:

| Name | CTC No. | Date of Issue | Place of Issue |
|---|---|---|---|
| Manuel V. Pangilinan | 14680296 | January 26, 2005 | Makati City |
| Napoleon L. Nazareno | 14698017 | February 4, 2005 | Makati City |
| Anabelle L. Chua | 18232215 | April 8, 2005 | Makati City |


STEPHEN Q. OLITOQUIT
Notary Public for the City of Makati
Commission No. M-123 until December 31, 2006
Roll of Atty. No. 37853
PTR No. 9403998C - 01/04/2005 Makati City
Lifetime IBP No. 02374 - 05/11/01
10th Floor, PLDT Tower I
Ayala Avenue, Makati City

Doc. No. 394;
Page No. 80;
Book No. XI;
Series of 2005.

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BOA/PRC Reg. No. 0001
SEC Accreditation No. 0042

## Report of Independent Auditors

The Stockholders and the Board of Directors
Philippine Long Distance Telephone Company

We have audited the accompanying consolidated balance sheets of Philippine Long Distance Telephone Company and Subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in equity and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the Philippines. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Philippine Long Distance Telephone Company and Subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the Philippines.

SyCip Gorres Velayo & Co
Betty C. Siy-Yap
Partner
CPA Certificate No. 57794
SEC Accreditation No. 0098-A
Tax Identification No. 102-100-627
PTR No. 9404045, January 3, 2005, Makati City

March 1, 2005

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# CONSOLIDATED BALANCE SHEETS

December 31, 2004 and 2003
(in million pesos, except par value amounts)

| | 2004 | 2003* (As restated - Note 2) |
|---|---|---|
| **ASSETS** | | |
| **Noncurrent Assets** | | |
| Property, plant and equipment (Notes 2, 8 and 18) | **194,525** | 194,790 |
| Investments in associates - at equity (Notes 2, 9, 10 and 18) | **8** | 1,180 |
| Investments-available-for-sale (Notes 2 and 25) | **104** | 117 |
| Investment properties (Notes 2 and 11) | **743** | 761 |
| Goodwill and intangible assets (Notes 2, 3, 10 and 12) | **3,864** | 372 |
| Deferred income tax assets (Notes 2 and 6) | **12,738** | 10,761 |
| Derivative assets (Notes 2 and 25) | **4,116** | 1,360 |
| Notes receivable (Notes 2, 13 and 25) | **286** | - |
| Prepayments (Note 18) | **997** | 1,022 |
| Other noncurrent assets (Note 2) | **1,237** | 1,148 |
| Total Noncurrent Assets | **218,618** | 211,511 |
| **Current Assets** | | |
| Cash and cash equivalents (Notes 2, 14 and 25) | **27,321** | 19,372 |
| Short-term investments (Notes 2 and 25) | **3,873** | 1,662 |
| Trade and other receivables (Notes 2, 15 and 25) | **10,404** | 16,908 |
| Inventories and supplies (Notes 2 and 16) | **2,140** | 2,676 |
| Derivative assets (Notes 2 and 25) | **335** | 262 |
| Prepayments (Note 18) | **1,271** | 2,699 |
| Other current assets (Notes 2 and 21) | **1,511** | 557 |
| Total Current Assets | **46,855** | 44,136 |
| | **265,473** | 255,647 |
| **EQUITY AND LIABILITIES** | | |
| **Equity** (Notes 2, 7 and 17) | | |
| Preferred stock, Php10 par value, authorized 822,500,000 shares; issued and outstanding 449,682,057 shares as at December 31, 2004 and 450,492,426 shares as at December 31, 2003 | **4,497** | 4,505 |
| Common stock, Php5 par value, authorized 234,000,000 shares; issued and outstanding 170,213,722 shares as at December 31, 2004 and 169,476,120 shares as at December 31, 2003 | **851** | 847 |
| Stock options issued (Note 22) | **181** | 286 |
| Equity portion of convertible preferred stock (Note 18) | **1,459** | 1,536 |
| Capital in excess of par value | **50,528** | 49,690 |
| Deficit (Note 7) | **(10,220)** | (36,735) |
| Cumulative translation adjustments (Note 25) | **362** | 549 |
| Total Equity Attributable to Equity Holders | **47,658** | 20,678 |
| Minority interest | **857** | 771 |
| Total Equity | **48,515** | 21,449 |

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# CONSOLIDATED BALANCE SHEETS (*continued*)

December 31, 2004 and 2003
(in million pesos, except par value amounts)

| | **2004** | 2003* (As restated - Note 2) |
|---|---|---|
| **Noncurrent Liabilities** | | |
| Interest-bearing financial liabilities - net of current portion (Notes 2, 8, 18, 23 and 25) | **135,988** | 166,110 |
| Deferred income tax liabilities (Notes 2 and 6) | **1,943** | 1,934 |
| Derivative liabilities (Notes 2 and 25) | **5,903** | 2,591 |
| Provision for onerous contracts and assessments - net of current portion (Notes 21, 23 and 24) | **3,951** | 3,632 |
| Pension and other benefits (Notes 2 and 22) | **2,908** | 3,687 |
| Customers' deposits | **2,174** | 2,176 |
| Other noncurrent liabilities (Notes 2, 17 and 19) | **7,159** | 5,811 |
| Total Noncurrent Liabilities | **160,026** | 185,941 |
| **Current Liabilities** | | |
| Accounts payable (Notes 2 and 25) | **7,029** | 5,192 |
| Accrued expenses and other current liabilities (Notes 2, 20, 25 and 26) | **14,811** | 11,819 |
| Unearned revenues (Note 2) | **2,892** | 3,106 |
| Derivative liabilities (Notes 2 and 25) | **474** | 91 |
| Current portion of provision for onerous contracts and assessments (Notes 23 and 24) | **597** | 394 |
| Current portion of interest-bearing financial liabilities (Notes 2, 8, 18, 23 and 25) | **28,501** | 26,238 |
| Dividends payable (Notes 2, 7, 18 and 25) | **652** | 577 |
| Income tax payable (Notes 2 and 6) | **1,976** | 840 |
| Total Current Liabilities | **56,932** | 48,257 |
| | **265,473** | 255,647 |

*See accompanying Notes to Consolidated Financial Statements.*
** Audited balances as at December 31, 2003 were restated to effect changes in accounting policies as discussed in Note 2.*

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# CONSOLIDATED STATEMENTS OF INCOME

For the Years Ended December 31, 2004, 2003 and 2002
(in million pesos, except per share amounts)

| | 2004 | 2003* | 2002* |
|---|---|---|---|
| | | (As restated - Note 2) | |
| **INCOME** (Notes 2 and 4) | | | |
| Service revenues | **115,254** | 100,604 | 82,093 |
| Non-service revenues (Note 5) | **6,269** | 10,714 | 12,145 |
| Other income (Note 5) | **4,729** | 965 | 857 |
| | **126,252** | 112,283 | 95,095 |
| **EXPENSES** (Notes 2 and 4) | | | |
| Depreciation and amortization (Note 8) | **21,405** | 23,606 | 22,082 |
| Financing costs (Note 5) | **19,420** | 25,386 | 21,766 |
| Compensation and benefits (Notes 5 and 22) | **12,025** | 14,859 | 11,026 |
| Cost of sales (Notes 5, 21 and 23) | **11,122** | 16,094 | 17,281 |
| Selling and promotions | **5,708** | 4,399 | 3,647 |
| Maintenance (Note 21) | **5,671** | 4,931 | 3,867 |
| Provisions (Notes 5, 15, 16, 21 and 23) | **4,845** | 4,839 | 4,696 |
| Professional and other service fees (Note 21) | **2,174** | 1,765 | 1,863 |
| Taxes and licenses (Note 24) | **1,997** | 1,783 | 1,085 |
| Rent | **1,907** | 2,201 | 2,651 |
| Insurance and security services (Note 21) | **1,644** | 1,528 | 1,354 |
| Asset impairment (Notes 5, 8 and 9) | **1,412** | 5,822 | 16,713 |
| Other expenses (Notes 5 and 21) | **4,002** | 3,394 | 2,526 |
| | **93,332** | 110,607 | 110,557 |
| **INCOME (LOSS) BEFORE INCOME TAX** | **32,920** | 1,676 | (15,462) |
| **PROVISION FOR (BENEFIT FROM) INCOME TAX** (Notes 2 and 6) | **4,948** | (545) | 888 |
| **NET INCOME (LOSS) FOR THE YEAR** | **27,972** | 2,221 | (16,350) |
| **ATTRIBUTABLE TO:** | | | |
| Equity holders | **28,044** | 2,123 | (16,353) |
| Minority interest | **(72)** | 98 | 3 |
| | **27,972** | 2,221 | (16,350) |
| **Earnings Per Common Share** (Note 7) | | | |
| Basic | **156.22** | 3.76 | (105.18) |
| Diluted | **156.22** | 3.76 | (105.18) |

*See accompanying Notes to Consolidated Financial Statements.*
** Audited balances as at December 31, 2003 and 2002 were restated to effect changes in accounting policies as discussed in Note 2.*

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

For the Years Ended December 31, 2004, 2003 and 2002
(in million pesos)

| | Preferred Stock | Common Stock | Stock Options Issued | Equity Portion of Convertible Preferred Stock | Capital in Excess of Par Value | Retained Earnings (Deficit) | Cumulative Translation Adjustments | Equity Attributable to Equity Holders of PLDT | Minority Interest | Total Equity |
|---|---|---|---|---|---|---|---|---|---|---|
| Balances at January 1, 2002 | | | | | | | | | | |
| As previously reported | 4,242 | 845 | - | - | 48,905 | 32,383 | - | 86,375 | 927 | 87,302 |
| Effect of changes in accounting policies (Note 2) | (113) | - | 279 | 1,547 | 304 | (48,479) | 472 | (45,990) | (380) | (46,370) |
| As restated | 4,129 | 845 | 279 | 1,547 | 49,209 | (16,096) | 472 | 40,385 | 547 | 40,932 |
| Changes in equity: | | | | | | | | | | |
| Net income (loss) for the year | | | | | | | | | | |
| As previously reported | - | - | - | - | - | 3,003 | - | 3,003 | (43) | 2,960 |
| Effect of changes in accounting policies (Note 2) | - | - | - | - | - | (19,356) | - | (19,356) | 46 | (19,310) |
| As restated | - | - | - | - | - | (16,353) | - | (16,353) | 3 | (16,350) |
| Cash dividends | - | - | - | - | - | (1,443) | - | (1,443) | - | (1,443) |
| Currency translation differences (Note 25) | - | - | - | - | - | - | 29 | 29 | - | 29 |
| Issuance of capital stock - net (Note 17) | 417 | 2 | - | (38) | 348 | - | - | 729 | - | 729 |
| Cancelled option shares (Note 22) | - | - | (7) | - | 7 | - | - | - | - | - |
| Cost of share-based payments | - | - | 76 | - | - | - | - | 76 | - | 76 |
| Partial redemption of Series IV Preferred Stock (Note 17) | (72) | - | - | - | - | - | - | (72) | - | (72) |
| Minority interest | - | - | - | - | - | - | - | - | (21) | (21) |
| Balances at December 31, 2002* (As restated - Note 2) | 4,474 | 847 | 348 | 1,509 | 49,564 | (33,892) | 501 | 23,351 | 529 | 23,880 |
| Balances at January 1, 2003 | | | | | | | | | | |
| As previously reported | 4,584 | 847 | - | - | 48,953 | 33,703 | - | 88,087 | 849 | 88,936 |
| Effect of changes in accounting policies (Note 2) | (110) | - | 348 | 1,509 | 611 | (67,595) | 501 | (64,736) | (320) | (65,056) |
| | 4,474 | 847 | 348 | 1,509 | 49,564 | (33,892) | 501 | 23,351 | 529 | 23,880 |
| Effect of changes in accounting policy on provisions and contingencies (Note 2) | - | - | - | - | - | (3,469) | - | (3,469) | - | (3,469) |
| As restated | 4,474 | 847 | 348 | 1,509 | 49,564 | (37,361) | 501 | 19,882 | 529 | 20,411 |
| Changes in equity: | | | | | | | | | | |
| Net income for the year | | | | | | | | | | |
| As previously reported | - | - | - | - | - | 11,182 | - | 11,182 | 93 | 11,275 |
| Effect of changes in accounting policies (Note 2) | - | - | - | - | - | (9,059) | - | (9,059) | 5 | (9,054) |
| As restated | - | - | - | - | - | 2,123 | - | 2,123 | 98 | 2,221 |
| Cash dividends | - | - | - | - | - | (1,497) | - | (1,497) | - | (1,497) |
| Currency translation differences (Note 25) | - | - | - | - | - | - | 48 | 48 | - | 48 |
| Issuance of capital stock - net (Note 17) | 31 | - | - | 27 | 74 | - | - | 132 | - | 132 |
| Cancelled option shares (Note 22) | - | - | (52) | - | 52 | - | - | - | - | - |
| Cost of share-based payments | - | - | (10) | - | - | - | - | (10) | - | (10) |
| Minority interest | - | - | - | - | - | - | - | - | 144 | 144 |
| Balances at December 31, 2003* (As restated - Note 2) | 4,505 | 847 | 286 | 1,536 | 49,690 | (36,735) | 549 | 20,678 | 771 | 21,449 |

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY *(continued)*

For the Years Ended December 31, 2004, 2003 and 2002
(in million pesos)

| | Preferred Stock | Common Stock | Stock Options Issued | Equity Portion of Convertible Preferred Stock | Capital in Excess of Par Value | Retained Earnings (Deficit) | Cumulative Translation Adjustments | Equity Attributable to Equity Holders of PLDT | Minority Interest | Total Equity |
|---|---|---|---|---|---|---|---|---|---|---|
| Balances at January 1, 2004 | | | | | | | | | | |
| As previously reported | 4,616 | 847 | - | - | 49,017 | 39,665 | - | 94,145 | 784 | 94,929 |
| Effect of changes in accounting policies (Note 2) | (111) | - | 286 | 1,536 | 673 | (76,400) | 549 | (73,467) | (13) | (73,480) |
| As restated | 4,505 | 847 | 286 | 1,536 | 49,690 | (36,735) | 549 | 20,678 | 771 | 21,449 |
| Changes in equity: | | | | | | | | | | |
| Net income (loss) for the year | - | - | - | - | - | 28,044 | - | 28,044 | (72) | 27,972 |
| Cash dividends | - | - | - | - | - | (1,529) | - | (1,529) | - | (1,529) |
| Currency translation differences (Note 25) | - | - | - | - | - | - | 17 | 17 | - | 17 |
| Net loss on available-for-sale financial assets (Note 25) | - | - | - | - | - | - | (5) | (5) | - | (5) |
| Net loss on cash flow hedges (Note 25) | - | - | - | - | - | - | (199) | (199) | - | (199) |
| Issuance of capital stock - net (Note 17) | (8) | 2 | - | (77) | 447 | - | - | 364 | - | 364 |
| Exercised shares | - | 2 | (114) | - | 386 | - | - | 274 | - | 274 |
| Cancelled option shares (Note 22) | - | - | (5) | - | 5 | - | - | - | - | - |
| Cost of share-based payments | - | - | 14 | - | - | - | - | 14 | - | 14 |
| Minority interest | - | - | - | - | - | - | - | - | 158 | 158 |
| Balances at December 31, 2004 | 4,497 | 851 | 181 | 1,459 | 50,528 | (10,220) | 362 | 47,658 | 857 | 48,515 |

*See accompanying Notes to Consolidated Financial Statements.*
** Audited balances as at December 31, 2003 and 2002 were restated to effect changes in accounting policies as discussed in Note 2.*

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# CONSOLIDATED STATEMENTS OF CASH FLOWS

For the Years Ended December 31, 2004, 2003 and 2002
(in million pesos)

| | 2004 | 2003* | 2002* |
|---|---|---|---|
| | | (As restated - Note 2) | |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | | |
| Income (loss) before income tax | **32,920** | 1,676 | (15,462) |
| Adjustments for: | | | |
| Depreciation and amortization | **21,405** | 23,606 | 22,082 |
| Interest on loans and related items - net of capitalized interest | **11,853** | 12,121 | 13,420 |
| Gain on debt exchange and debt restructuring (Notes 5 and 18) | **(4,419)** | (101) | (189) |
| Provision for doubtful accounts (Note 5) | **3,949** | 4,092 | 4,136 |
| Accretion on financial liabilities - net (Note 5) | **3,452** | 2,667 | 2,324 |
| Foreign exchange losses - net | **2,684** | 9,490 | 7,744 |
| Asset impairment | **1,412** | 5,822 | 16,713 |
| Interest income | **(942)** | (513) | (237) |
| Loss on derivative transactions - net | **781** | 460 | 13 |
| Write-down of inventories at net realizable value | **577** | 337 | 560 |
| Provision for onerous contracts | **319** | 410 | - |
| Dividends on preferred stock subject to mandatory redemption | **284** | 254 | 240 |
| Equity in net losses of associates | **74** | 79 | 134 |
| Others | **656** | 772 | 921 |
| Operating income before working capital changes | **75,005** | 61,172 | 52,399 |
| Decrease (increase) in: | | | |
| Trade and other receivables | **2,296** | (3,910) | 2,807 |
| Inventories and supplies | **7** | 1,578 | 176 |
| Prepayments | **119** | 365 | (440) |
| Other current assets | **(873)** | (316) | 802 |
| Increase (decrease) in: | | | |
| Accounts payable | **1,841** | (3,526) | (3,135) |
| Accrued expenses and other current liabilities | **1,589** | 733 | 1,709 |
| Unearned revenues | **(213)** | 655 | 197 |
| Pension and other benefits | **(779)** | 1,674 | 476 |
| Cash generated from operations | **78,992** | 58,425 | 54,991 |
| Income taxes paid | **(5,478)** | (2,453) | (353) |
| Net cash provided by operating activities | **73,514** | 55,972 | 54,638 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | | |
| Additions to property, plant and equipment | **(20,567)** | (17,132) | (15,561) |
| Proceeds from disposal of property, plant and equipment | **112** | 226 | 233 |
| Interest paid - capitalized to property, plant and equipment | **(595)** | (887) | (1,343) |
| Proceeds from disposal of investments in associates | **2** | 108 | 1 |
| Payments for purchase of investments - net of cash acquired | **(1,366)** | (236) | (34) |
| Additions to investment properties | **(3)** | (16) | - |
| Increase in short-term investments | **(2,212)** | (1,662) | - |
| Investments in notes receivable | **(286)** | - | - |
| Interest received | **954** | 484 | 229 |
| Decrease (increase) in other noncurrent assets | **22** | (495) | (727) |
| Net cash used in investing activities | **(23,939)** | (19,610) | (17,202) |

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# CONSOLIDATED STATEMENTS OF CASH FLOWS *(continued)*

For the Years Ended December 31, 2004, 2003 and 2002
(in million pesos)

| | 2004 | 2003* | 2002* |
|---|---|---|---|
| | | (As restated - Note 2) | |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | | |
| Proceeds from long-term debt | **12,131** | 15,361 | 32,566 |
| Payments of long-term debt | **(39,548)** | (31,030) | (38,516) |
| Proceeds from notes payable | **457** | 3,135 | 8,058 |
| Payments of notes payable | **(2,412)** | (1,698) | (13,802) |
| Payments of obligations under capital lease | **(136)** | (139) | (38) |
| Interest paid - net of capitalized portion | **(12,310)** | (12,647) | (14,527) |
| Cash dividends paid | **(1,456)** | (1,349) | (1,341) |
| Proceeds from issuance of capital stock | **281** | 95 | 464 |
| Increase (decrease) in: | | | |
| Capital expenditures under long-term financing | **839** | 1,615 | (5,454) |
| Advance payment under receivable purchase facility | **-** | (369) | 2,530 |
| Customers' deposits | **(4)** | (93) | (164) |
| Other noncurrent liabilities | **601** | (818) | (531) |
| Redemption of preferred stock | **-** | - | (72) |
| Net cash used in financing activities | **(41,557)** | (27,937) | (30,827) |
| **EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS** | **(69)** | (28) | 90 |
| **NET INCREASE IN CASH AND CASH EQUIVALENTS** | **7,949** | 8,397 | 6,699 |
| **CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR** | **19,372** | 10,975 | 4,276 |
| **CASH AND CASH EQUIVALENTS AT END OF YEAR** | **27,321** | 19,372 | 10,975 |

*See accompanying Notes to Consolidated Financial Statements.*
** Audited balances as at December 31, 2003 and 2002 were restated to effect changes in accounting policies as discussed in Note 2.*

# PHILIPPINE LONG DISTANCE TELEPHONE COMPANY AND SUBSIDIARIES
# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. Corporate Information

The Philippine Long Distance Telephone Company, or PLDT, or Parent Company, was incorporated under the old Corporation Law of the Philippines (Act 1459, as amended) on November 28, 1928, following the merger of four telephone companies under common U.S. ownership. In 1967, effective control of PLDT was sold by General Telephone and Electronics Corporation (a major shareholder since PLDT's incorporation) to a group of Filipino businessmen. In 1981, in furtherance of the then existing policy of the Philippine government to integrate the Philippine telecommunications industry, PLDT purchased substantially all of the assets and liabilities of the Republic Telephone Company.

The common shares of PLDT are listed and traded on the Philippine Stock Exchange, or PSE, and prior to October 19, 1994, were listed and traded on the American Stock Exchange and Pacific Exchange in the United States. On October 19, 1994, an American Depositary Receipts, or ADRs, facility was established pursuant to which Citibank N.A., as depositary, issued ADRs evidencing American Depositary Shares, or ADSs, with each ADS representing one PLDT common share. JP Morgan Chase Bank has been appointed as successor depositary for PLDT's ADRs effective February 10, 2003. The ADSs are listed and traded on the New York Stock Exchange and the Pacific Exchange in the United States.

PLDT's charter, like those of all other Philippine corporations, was initially limited to a period of 50 years but has since been extended twice for 25 years each, the last extension being for an additional 25-year period to 2028. Under its amended charter (Republic Act No. 7082), which became effective on August 24, 1991, PLDT is authorized to provide virtually every type of telecommunications service, both within the Philippines and between the Philippines and other countries.

PLDT operates under the jurisdiction of the Philippine National Telecommunications Commission, or NTC, which jurisdiction extends, among other things, to approving major services offered by PLDT and certain rates charged by PLDT.

The registered office address of PLDT is Ramon Cojuangco Building, Makati Avenue, Makati City, Philippines.

Our consolidated financial statements as at December 31, 2004 and 2003 and for the years ended December 31, 2004, 2003 and 2002 were approved and authorized for issuance by the Board of Directors on March 1, 2005.

## 2. Summary of Significant Accounting Policies

### *Basis of Preparation*

Our consolidated financial statements have been prepared in conformity with Philippine Generally Accepted Accounting Principles, or Philippine GAAP, under the historical cost convention as modified by the revaluation of derivative financial instruments, available-for-sale financial assets and investment properties that are measured at fair value. The carrying values of recognized assets and liabilities that are hedged are adjusted to record changes in the fair values attributable to the risks that are being hedged.

Our consolidated financial statements are presented in Philippine pesos and all values are rounded to the nearest million except when otherwise indicated.

#### *Changes in Accounting Policies*

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

The International Accounting Standards Board, or IASB, has assumed from the IASC the responsibility for setting IAS. The standards issued by the IASB are designated as International Financial Reporting Standards, or IFRS. Upon its adoption, the IASB also adopted the IAS issued by the IASC. The IASB carried on improvements in certain IAS in preparation for the full adoption of IFRS effective January 1, 2005.

The ASC has re-named the new standards "Philippine Accounting Standards", or PAS, and "Philippine Financial Reporting Standards", or PFRS, to correspond with the adopted IAS and IFRS of the IASB. ASC standards were previously designated as "Statements of Financial Accounting Standards", or SFAS.

The accounting policies adopted are consistent with those of the previous financial year except that we have adopted the following new accounting standards effective beginning January 1, 2004 and accounting standards intended to be mandatory beginning on or after January 1, 2005. Prior years' consolidated financial statements herein have been restated to give effect to the provisions of the new standards adopted.

***Philippine Accounting Standards, or PAS/Philippine Financial Reporting Standards, or PFRS, effective January 1, 2004***

***PAS 12, "Income Taxes".*** PAS 12 prescribes the accounting treatment for deferred income taxes. This standard requires the use of the balance sheet liability method in accounting for deferred income taxes. It requires the recognition of a deferred tax liability and, subject to certain conditions, a deferred tax asset, for all temporary differences with certain exceptions. This standard provides for the recognition of a deferred tax asset when it is probable that taxable income will be available against which the deferred tax asset can be used. It also provides for the recognition of a deferred tax liability with respect to asset revaluations and fair value adjustments arising from business combinations. Our adoption of this standard did not have any material effect in our consolidated statements of income and only affected certain classifications of the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Deferred income tax assets | 196 | 12 |
| **Current assets** | | |
| Deferred income tax assets | (6,523) | (4,439) |
| Prepayments | 1,907 | 1,262 |
| **Noncurrent liabilities** | | |
| Deferred income tax liabilities | (4,420) | (3,165) |

***PAS 17, "Leases".*** PAS 17 requires the capitalization of finance leases, which transfer substantially all the risks and benefits incidental to ownership of leased item, at the inception of the lease at the fair value of leased property or, if lower, at the present value of the minimum lease payments. PAS 17 also requires that a lease, where the lessor retains substantially all the risks and benefits of ownership of the asset, be classified as operating leases, which should be recognized as an expense in the income statement on a straight-line basis over the lease term. Our adoption of this standard reduced our consolidated net income by Php89 million (Php55 million after tax effect), Php18 million (Php15 million after tax effect) and Php125 million (Php88 million after tax effect) for the years ended December 31, 2004, 2003 and 2002, respectively, and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Property, plant and equipment | 83 | 103 |
| Deferred income tax assets | 49 | 44 |
| **Equity** | (562) | (547) |
| **Noncurrent liabilities** | | |
| Deferred income tax liabilities | (181) | (185) |
| Other noncurrent liabilities | 499 | 623 |
| **Current liabilities** | | |
| Accounts payable | 124 | 39 |
| Accrued expenses and other current liabilities | 252 | 217 |

***Philippine Accounting Standards, or PAS/Philippine Financial Reporting Standards, or PFRS, effective January 1, 2005***

We have elected to early adopt the following standards which are mandatory for financial years beginning on or after January 1, 2005.

***PAS 19, "Employee Benefits".*** PAS 19 requires the use of the projected unit credit method in measuring retirement benefit expense and a change in the manner of computing benefit expense relating to past service cost and actuarial gains and losses. Past service cost is recognized as an expense on a straight-line basis over the average period until the benefits become vested. On the initial adoption of this standard, the effect of the change in accounting policy includes all actuarial gains and losses that arose in earlier periods even if they fall inside the 10% corridor. In subsequent periods, portion of actuarial gains or losses is recognized as income or expense if the cumulative unrecognized actuarial gains and losses at the end of the previous reporting period exceeded the greater of: (i) 10% of the present value of the defined benefit obligation at that date (before deducting plan assets); and (ii) 10% of the fair value of any planned assets at that date by dividing the excess determined by the expected average remaining working lives of the employees participating in that plan is recognized immediately as income or expense. Our adoption of this standard reduced our consolidated net income by Php28 million (Php19 million after tax effect) for the year ended December 31, 2004 by Php1,548 million (Php1,112 million after tax effect) for the year ended December 31, 2003 and by Php433 million (Php301 million after tax effect) for the year ended December 31, 2002, and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Deferred income tax assets | 3 | - |
| Prepayments | (1,183) | - |
| **Current assets** | | |
| Prepayments | (642) | (19) |
| **Equity** | (3,059) | (1,946) |
| **Noncurrent liabilities** | | |
| Deferred income tax liabilities | (1,339) | (906) |
| Pension and other benefits | 2,416 | 2,833 |
| **Current liabilities** | | |
| Accrued expenses and other current liabilities | 160 | - |

***PAS 21, "The Effects of Changes in Foreign Exchange Rates".*** PAS 21 requires the recognition of foreign exchange gains and losses in the period they are incurred. Upon the adoption of PAS 21, we adjusted previously recorded undepreciated capitalized foreign exchange losses, net of exchange losses that qualify as borrowing cost and income tax effect, against beginning retained earnings, to the extent that such capitalized amounts do not meet the conditions for capitalization under the new accounting standard, and restated prior years' consolidated financial statements. Further, PAS 21 requires the determination of the functional currency of an entity. Exchange differences from any retranslation are taken directly as a separate component of equity. On disposal of an entity with functional currency other than the Philippine peso, the deferred cumulative amount recognized in equity relating to that particular foreign operation shall be recognized in the consolidated income statement. Our adoption of this standard increased our consolidated net income by Php3,649 million (Php2,477 million after tax effect) for the year ended December 31, 2004, and decreased our consolidated net income by Php875 million (Php596 million after tax effect) for the year ended December 31, 2003 and Php1,520 million (Php946 million after tax effect) for the year ended December 31, 2002, and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Property, plant and equipment | (52,460) | (53,070) |
| Investments in associates - at equity | (343) | (344) |
| Deferred income tax assets | 10,496 | 8,520 |
| **Equity** | (37,111) | (36,590) |
| **Noncurrent liabilities** | | |
| Deferred income tax liabilities | (5,205) | (8,309) |
| Other noncurrent liabilities | 9 | 5 |

***PAS 27, "Consolidated and Separate Financial Statements".*** PAS 27 supersedes SFAS 27/IAS 27, "Consolidated Financial Statements and Accounting for Investments in Subsidiaries". Under PAS 27, the exclusion of a subsidiary from consolidation when there are severe long-term restrictions that significantly impair a subsidiary's ability to transfer funds to the parent company under the superseded standard was removed. Consequently, Pilipino Telephone Corporation, or Piltel, was required to be included in our consolidated financial statements retrospectively. Our adoption of this standard increased our consolidated net income by Php10,275 million for the year ended December 31, 2004 and decreased our consolidated net income by Php3,445 million and Php17,581 million for the years ended December 31, 2003 and 2002, respectively. Presented below is the summarized statements of income of Piltel before PAS 27 application for the years ended December 31, 2003 and 2002:

| | 2003 | 2002 |
|---|---|---|
| | (in million pesos, except per share amounts) | |
| **Statements of Income** | | |
| Revenues and other income | 4,484 | 2,968 |
| Expenses | (7,752) | (24,797) |
| Income tax | (79) | - |
| Net loss before PAS adjustments | (3,347) | (21,829) |
| Basic earnings per share | (2.77) | (13.66) |

In addition, the consolidation of Piltel has increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002:

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Property, plant and equipment | 3,054 | 4,946 |
| Other noncurrent assets | (531) | 373 |
| **Current assets** | | |
| Cash and cash equivalents | 109 | 98 |
| Trade and other receivables | (920) | (1,393) |
| Inventories and supplies | 251 | 81 |
| Prepayments | (151) | 239 |
| Other current assets | 49 | 2 |
| **Equity** | (19,446) | (16,424) |
| **Noncurrent liabilities** | | |
| Interest-bearing financial liabilities - net of current portion | 23,364 | 21,629 |
| Customers' deposits | (17) | (17) |
| Other noncurrent liabilities | (3,012) | (2,895) |
| **Current liabilities** | | |
| Accounts payable | (2,180) | 57 |
| Accrued expenses and other current liabilities | 1,903 | 1,116 |
| Unearned revenues | 1,097 | 423 |
| Current portion of interest-bearing financial liabilities | 68 | 452 |
| Dividends payable | 5 | 5 |
| Income tax payable | 79 | - |

***PAS 32, "Financial Instruments: Disclosure and Presentation".*** PAS 32 covers the disclosure and presentation of all financial instruments. This standard requires more comprehensive disclosures about a company's financial instruments, whether recognized or unrecognized in the financial statements. New disclosure requirements include terms and conditions of financial instruments used, types of risks associated with both recognized and unrecognized financial instruments (market risk, price risk, credit risk, liquidity risk, and cash flow risk), fair value information of both recognized and unrecognized financial assets and financial liabilities, and our financial risk management policies and objectives. This standard also requires financial instruments to be classified as liabilities or equity in accordance with their substance and not their legal form. Consequently, we have designated PLDT's Convertible Preferred Stock Series V, VI and VII as compound instruments consisting of liability and equity components. The total fair value of the Convertible Preferred Stock Series V, VI and VII was determined at issue date, of which the aggregate fair value of the liability component of the Series V, VI and VII Convertible Preferred Stock as at date of issuance is included as a financial liability under *Interest-bearing Financial Liabilities* account in the consolidated balance sheets. The residual amount was assigned as the equity component.

Our adoption of this standard reduced our consolidated net income by Php2,281 million (Php1,574 million after tax effect) for the year ended December 31, 2004, Php2,474 million (Php1,775 million after tax effect) for the year ended December 31, 2003 and Php1,991 million (Php1,353 million after tax effect) for the year ended December 31, 2002, and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Equity** | (14,481) | (12,811) |
| **Noncurrent liabilities** | | |
| Deferred income tax liabilities | 1,747 | 2,448 |
| Interest-bearing financial liabilities - net of current portion | 12,734 | 10,363 |

***PAS 39, "Financial Instruments: Recognition and Measurement".*** PAS 39 establishes the accounting and reporting standards for recognizing and measuring our financial assets and financial liabilities. This standard requires a financial asset or financial liability to be recognized initially at cost, which is the fair value of the consideration given (in the case of an asset) or received (in the case of a liability). Subsequent to initial recognition, we are to continue to measure financial assets at their fair values, except for loans and receivables and held-to-maturity investments, which are measured at cost or amortized cost using the effective interest rate method. Financial liabilities are subsequently measured at cost or amortized cost, except for liabilities classified as "at fair value through profit and loss" and derivatives, which are measured at fair value.

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

Our adoption of this standard increased our consolidated net income by Php2,707 million (Php2,105 million after tax effect) for the year ended December 31, 2004 and decreased our consolidated net income by Php2,843 million (Php2,034 million after tax effect) for the year ended December 31, 2003 and Php1,307 million (Php865 million after tax effect) for the year ended December 31, 2002 and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Derivative assets | 1,361 | 271 |
| Other noncurrent assets | (20) | - |
| **Current assets** | | |
| Inventories and supplies | 4 | - |
| Derivative assets | 235 | 55 |
| Other current assets | (39) | - |
| **Equity** | 1,045 | 3,078 |
| **Noncurrent liabilities** | | |
| Interest-bearing financial liabilities - net of current portion | (2,634) | (4,963) |
| Deferred income tax liabilities | 584 | 1,394 |
| Derivative liabilities | 2,591 | 750 |
| **Current liabilities** | | |
| Accounts payable | 3 | - |
| Derivative liabilities | (5) | 175 |
| Accrued expenses and other current liabilities | (43) | (108) |

***PAS 40, "Investment Property".*** PAS 40 prescribes the accounting treatment for investment properties which is defined as land and/or building held to generate income or for capital appreciation or both. An investment property is initially recognized at cost. Subsequent to initial recognition, an investment property is either carried at (i) cost, less accumulated depreciation or any accumulated impairment losses, or (ii) fair value, wherein fair value movements are recognized as income or expense. Transfers to or from investment property classification are made only when there is evidence of a change in use.

Our adoption of this standard, where we opted to carry our investment properties at fair value subsequent to initial recognition, decreased our net income by Php17 million (Php12 million after tax effect) for the year ended December 31, 2004 and Php26 million (Php18 million after tax effect) for the year ended December 31, 2003, and Php15 million (Php10 million after tax effect) for the year ended December 31, 2002, and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Property, plant and equipment | (414) | (402) |
| Investment properties | 761 | 776 |
| Deferred income tax assets | (111) | (120) |
| **Equity** | 236 | 254 |

***PFRS 2, "Share-Based Payment".*** PFRS 2 requires an entity to recognize goods or services received or acquired in a share-based payment transaction when it obtains the goods or as the services are received. The entity shall recognize a corresponding increase in equity if the goods or services were received in an equity-settled share-based payment transaction, or a liability if the goods or services were acquired in a cash-settled share-based payment transaction. In line with our adoption of PFRS 2, we recognized in our consolidated statements of income the costs of employees' and directors' share options and other share-based incentives by using an option-pricing model, further details of which are given in *Note 22 - Employee Benefits*.

Our adoption of this standard decreased our consolidated net income by Php674 million (Php477 million after tax effect) for the year ended December 31, 2004 and Php76 million (Php76 million after tax effect) for the year ended December 31, 2002, and increased our net income by Php10 million (Php10 million after tax effect) for the year ended December 31, 2003, and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Equity** | | |
| Stock options issued | 286 | 348 |
| Capital in excess of par value | 59 | 7 |
| Deficit | (345) | (355) |

***PFRS 3, "Business Combinations", PAS 36, "Impairment of Assets" and PAS 38, "Intangible Assets".*** PFRS 3 requires all business combinations within its scope to be accounted for by applying the purchase method. In addition, this standard requires the acquirer to initially measure separately the identifiable assets, liabilities and contingent liabilities at their fair values, at acquisition date, irrespective of the extent of any minority interest.

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

Moreover, the useful lives of intangible assets are assessed at the individual asset level as having either a finite or indefinite life. Where an intangible asset has a finite life, it will be amortized over its useful life. Amortization periods and methods for intangible assets with finite useful lives are reviewed annually or earlier where an indicator of impairment exists. Intangibles assessed as having indefinite useful lives are not amortized, as there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the Group. However, intangibles with indefinite useful lives are reviewed annually to ensure their carrying values do not exceed the recoverable amounts regardless whether an indicator of impairment is present.

Our adoption of this standard decreased our net income by Php156 million (Php107 million after tax effect) for the year ended December 31, 2004 and Php2 million (Php1 million after tax effect) for the year ended December 31, 2003 and have increased (decreased) the following accounts in our consolidated balance sheet as at December 31, 2003.

| | Increase (Decrease) |
|---|---|
| | (in million pesos) |
| **Noncurrent assets** | |
| Goodwill and intangible assets | 312 |
| Other noncurrent assets | (172) |
| **Equity** | 41 |
| **Noncurrent liabilities** | |
| Deferred income tax liabilities | 99 |

***PFRS 5, "Noncurrent Assets Held-for-Sale and Discontinued Operations".*** Under the superseded SFAS 35/IAS 35, "Discontinuing Operations," we would have previously recognized a discontinued operation at the earlier of when (a) we enter into a binding agreement; and (b) the Board of Directors have approved and announced a formal disposal plan. PFRS 5 now requires an operation to be classified as discontinued when the criteria to be classified as held-for-sale have been met or we have disposed of the operation.

In addition to these standards referred to above, we have adopted the following standards during the year and comparative figures have been amended as required:

- PAS 1 - "Presentation of Financial Statements";
- PAS 2 - "Inventories";
- PAS 8 - "Accounting Policies, Changes in Accounting Estimates and Errors";
- PAS 10 - "Events After the Balance Sheet Date";
- PAS 24 - "Related Party Disclosures";
- PAS 28 - "Investments in Associates";
- PAS 31 - "Interests in Joint Ventures"; and
- PAS 33 - "Earnings Per Share"

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

We are legally required under various lease agreements to dismantle the installations and restore the leased sites to their original state at the end of the lease contract term. Our adoption of this standard reduced our consolidated net income by Php114 million (Php77 million after tax effect), Php107 million (Php73 million after tax effect) and Php41 million (Php28 million after tax effect) for the years ended December 31, 2004, 2003 and 2002, respectively, and have increased (decreased) the following accounts in our consolidated balance sheets as at December 31, 2003 and 2002.

| | Increase (Decrease) | |
|---|---|---|
| | 2003 | 2002 |
| | (in million pesos) | |
| **Noncurrent assets** | | |
| Property, plant and equipment | 183 | 91 |
| Deferred income tax assets | 126 | 62 |
| **Equity** | (143) | (70) |
| **Noncurrent liabilities** | | |
| Deferred income tax liabilities | 58 | 29 |
| Other noncurrent liabilities | 394 | 194 |

We will adopt PAS 16 in 2005, which requires us to determine the depreciation charge separately for each significant part of an item of property, plant and equipment. The impact of this requirement cannot be quantified until a detailed inspection of property, plant and equipment is performed in 2005.

Adoption of the above standards involved changes in accounting policies and we have accordingly restated our comparative consolidated financial statements retroactively in accordance with the transitional provisions in these standards. Reconciliations of the effects of these new standards, as they apply to us, on our equity and net income are set out below.

| | Equity | | | Net Income | | |
|---|---|---|---|---|---|---|
| | December 31, | | | For the Years Ended December 31, | | |
| | 2003 | 2002 | 2001 | 2003 | 2002 | 2001 |
| | (in million pesos, except per share amounts) | | | | | |
| **As previously reported** | 94,929 | 88,936 | 87,302 | 11,182 | 3,003 | 2,699 |
| PAS 16 - Property, Plant and Equipment | (143) | (70) | (43) | (73) | (28) | (18) |
| PAS 17 - Leases | (562) | (547) | (458) | (15) | (88) | (90) |
| PAS 19 - Employee Benefits | (3,059) | (1,946) | (1,645) | (1,112) | (301) | (179) |
| PAS 21 - The Effects of Changes in Foreign Exchange Rates | (37,111) | (36,590) | (37,592) | (596) | 946 | 8,369 |
| PAS 27 - Consolidated and Separate Financial Statements | (19,446) | (16,424) | 952 | (3,445) | (17,581) | (8,321) |
| PAS 32 - Financial Instruments: Disclosure and Presentation | (14,481) | (12,811) | (11,792) | (1,775) | (1,353) | (3,590) |
| PAS 39 - Financial Instruments: Recognition and Measurement | 1,045 | 3,078 | 3,943 | (2,034) | (865) | 3,988 |
| PAS 40 - Investment Property | 236 | 254 | 265 | (18) | (10) | 49 |
| PFRS 2 - Share-Based Payment | - | - | - | 10 | (76) | (119) |
| PFRS 3 - Business Combinations, PAS 36 - Impairment of Assets and PAS 38 - Intangible Assets | 41 | - | - | (1) | - | - |
| **As restated** | 21,449 | 23,880 | 40,932 | 2,123 | (16,353) | 2,788 |
| **Earnings per common share, as previously reported** | | | | 55.74 | 8.03 | 7.10 |
| Earnings per share impact of restated items: | | | | | | |
| PAS 16 - Property, Plant and Equipment | | | | (0.43) | (0.16) | (0.11) |
| PAS 17 - Leases | | | | (0.09) | (0.52) | (0.54) |
| PAS 19 - Employee Benefits | | | | (6.57) | (1.78) | (1.06) |
| PAS 21 - The Effects of Changes in Foreign Exchange Rates | | | | (3.52) | 7.06 | 49.62 |
| PAS 27 - Consolidated and Separate Financial Statements | | | | (20.34) | (103.98) | (49.34) |
| PAS 32 - Financial Instruments: Disclosure and Presentation | | | | (10.40) | (8.36) | (19.81) |
| PAS 39 - Financial Instruments: Recognition and Measurement | | | | (10.57) | (5.12) | 23.65 |
| PAS 40 - Investment Property | | | | (0.11) | 0.10 | 6.69 |
| PFRS 2 - Share-Based Payment | | | | 0.06 | (0.45) | (0.71) |
| PFRS 3 - Business Combinations, PAS 36 - Impairment of Assets and PAS 38 - Intangible Assets | | | | (0.01) | - | - |
| **Earnings per common share, as restated** | | | | 3.76 | (105.18) | 15.49 |

In 2003, we adopted SFAS 37/IAS 37, "Provisions, Contingent Liabilities and Contingent Assets", which became effective in the Philippines for financial statements covering periods beginning on or after January 1, 2003. SFAS 37/IAS 37 requires that provisions be recognized when (i) an enterprise has a present obligation (legal or constructive) as a result of a past event; (ii) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and (iii) a reliable estimate can be made of the amount of the obligation. SFAS 37/IAS 37 also provides that present obligations under onerous contracts are required to be recognized and measured as a provision. The standard defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceeded the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract.

SFAS 37/IAS 37 prescribes the retroactive adjustment to the opening balance of retained earnings for the period in which the standard is first adopted. As allowed under the transitory provisions, we elected not to adjust the opening balance of retained earnings for the earliest period presented and not to restate comparative information.

We made a reasonable estimate of the amount necessary in the event the obligations stated below, shall be settled and have made the appropriate provisions in our consolidated financial statements as at December 31, 2003:

(i) NTC supervision and regulation fees;
(ii) Local business tax assessments; and
(iii) Air Time Purchase Agreement with ACeS International Limited, or AIL.

The effect of the application of SFAS 37/IAS 37 was a reduction of Php3,469 million in the beginning deficit of 2003.

### *Basis of Consolidation*

Our consolidated financial statements include the financial statements of PLDT and those of the following subsidiaries (collectively, the PLDT Group), which were all incorporated in the Philippines except for PLDT Global Corporation, which was incorporated in the British Virgin Islands.

| Name of Subsidiary/Investee | Principal Activity | Percentage of Ownership December 31, 2004 | 2003 | 2002 |
|---|---|---|---|---|
| **Wireless** | | | | |
| Smart Communications, Inc., or Smart, and subsidiaries | Cellular mobile services | **100.0** | 100.0 | 100.0 |
| Pilipino Telephone Corporation, or Piltel, and subsidiaries | Cellular mobile and telecommunications services | **92.1** | 45.3 | 45.3 |
| Telesat, Inc., or Telesat | Satellite communications services | **94.4** | 94.4 | 94.4 |
| ACeS Philippines Cellular Satellite Corporation, or ACeS Philippines | Satellite phone services | **100.0** | 100.0 | 100.0 |
| Mabuhay Satellite Corporation (formerly Mabuhay Philippines Satellite Corporation), or Mabuhay Satellite | Satellite communications services | **67.0** | 67.0 | 67.0 |
| **Fixed Line** | | | | |
| PLDT Clark Telecom, Inc., or Clark Telecom | Telecommunications services | **100.0** | 100.0 | 100.0 |
| Subic Telecommunications Company, Inc., or Subic Telecom | Telecommunications services | **100.0** | 100.0 | 100.0 |
| Smart-NTT Multimedia, Inc., or SNMI | Data and network services | **100.0** | 100.0 | 100.0 |
| PLDT Global Corporation, or PLDT Global, and subsidiaries | Telecommunications services | **100.0** | 100.0 | 100.0 |
| PLDT-Maratel, Inc. (formerly Maranao Telephone Company, Inc.), or Maratel | Telecommunications services | **97.5** | 97.5 | 97.5 |
| Bonifacio Communications Corporation, or BCC | Telecommunications, infrastructure and related value-added services | **75.0** | 75.0 | 37.5 |
| **Information and Communications Technology** | | | | |
| ePLDT, Inc., or ePLDT, and subsidiaries (including Vocativ, Inc., see *Note 18 - Interest-bearing Financial Liabilities*) | Information and communications infrastructure for internet-based services, e-commerce, call centers and IT-related services | **100.0** | 100.0 | 100.0 |

Subsidiaries are consolidated from the date when control is transferred to the PLDT Group and cease to be consolidated from the date when control is transferred out of the PLDT Group.

We prepare our consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances. Intercompany balances and transactions, including intercompany profits and unrealized profits and losses, are eliminated.

Minority interests represent the equity interests in Piltel, Telesat, Mabuhay Satellite, Maratel and BCC not held by the PLDT Group.

***Changes in Piltel Shareholding***

To integrate the PLDT Group's wireless holdings, on July 2, 2004, Smart entered into a Sale and Purchase Agreement with PLDT to acquire the latter's 59.3 million shares of Piltel Series K Class I Convertible Preferred Stock for Php2,066 million. On July 9, 2004, Smart converted a total of 4.8 million shares of Piltel Series K Class I Convertible Preferred Stock into 820.3 million shares of Piltel common stock, equivalent to 32.7% of the total outstanding shares of common stock of Piltel after such conversion. Such initial conversion resulted in the dilution of PLDT's direct ownership in Piltel from 45.3% to 30.5%. On December 28, 2004, Smart converted its remaining 54.5 million shares of Piltel Series K Class I Convertible Preferred Stock into 9,260 million shares of Piltel common stock. After the full conversion, Smart now holds a total of 10,080 million shares of common stock of Piltel, equivalent to 85.6% of the resulting total outstanding shares of common stock after such conversion. In aggregate therefore, ownership of Piltel by PLDT and Smart is 92.1%. Transactions of entities under common control were accounted for at historical cost.

***ePLDT investments in ePLDT Ventus, Inc., or Ventus, and netGames, Inc., or netGames***

In the second half of 2004, ePLDT made investments in Ventus and netGames, which are newly incorporated companies.

Ventus is a wholly-owned call center subsidiary of ePLDT which was incorporated and registered with the SEC on October 5, 2004. ePLDT subscribed to 70 million shares at a total par value of Php70 million. Ventus has a 400-seat call center facility located in Iloilo province has commenced full commercial operations in March 2005. Ventus will be expanding in Metro Manila with a 678-seat call center facility to accommodate current and new client requirements. This facility is expected to be completed by November 2005.

ePLDT owns 63% of 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 was incorporated on June 21, 2004. netGames commenced full commercial operations in February 2005.

***Investments in Associates***

Investments in associates in which we exercise significant influence and which are neither a subsidiary nor a joint venture of the PLDT Group are accounted for under the equity method of accounting. Under the equity method, our investments in associates are carried in the consolidated balance sheets at cost plus post-acquisition changes in our share in net assets of the investees, less impairment in value, if any. The consolidated statements of income reflect our share of the results of operations of the associate. Where there has been a change recognized directly in the associates' equity, we recognize our share of any changes and disclose this, when applicable in the consolidated statements of changes in equity.

***Foreign Currency Translation***

The functional and presentation currency of the PLDT Group (except for Mabuhay Satellite) is the Philippine peso. Transactions in foreign currencies are initially recorded in the functional currency rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated at the functional currency rate of exchange ruling at the balance sheet date. All differences are taken to the consolidated statements of income except for foreign exchange losses that qualified as capitalizable borrowing costs during construction period. For income tax purposes, exchange gains or losses are treated as taxable income or deductible expenses in the period such are realized.

The functional currency of Mabuhay Satellite is United States dollars. As at the reporting date, the assets and liabilities of this subsidiary are translated into the presentation currency of the PLDT Group at the rate of exchange ruling at the balance sheet date and, its income and expenses are translated at the weighted average exchange rate for the year. The exchange differences arising on retranslation are taken directly to a separate component of equity as cumulative translation adjustments. On disposal of this subsidiary, the deferred cumulative amount of translation adjustments recognized in equity relating to this particular subsidiary shall be recognized in the consolidated statements of income.

***Property, Plant and Equipment***

Property, plant and equipment, except for land, are stated at cost less accumulated depreciation and amortization and any impairment in value. Land is stated at cost less any impairment in value.

The initial cost of property, plant and equipment comprises its purchase price and any costs directly attributable in bringing the asset to its working condition and location for its intended use. Expenditures incurred after the assets have been put into operation, such as repairs and maintenance and overhaul costs, are normally charged to income in the period the costs are incurred. In situations where it can be clearly demonstrated that the expenditures have resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment beyond its originally assessed standard of performance, the expenditures are capitalized as additional costs of property, plant and equipment. Cost also includes asset retirement obligation, interest on borrowed funds used during the construction period and qualified borrowing costs from foreign exchange losses related to foreign currency-denominated liabilities used to acquire such assets. When assets are sold or retired, their costs and accumulated depreciation, amortization and impairment losses, if any, are eliminated from the accounts and any gain or loss resulting from their disposal is included in the consolidated statement of income of such period.

Depreciation and amortization are calculated on a straight-line basis over the following estimated useful lives of the assets:

| | Estimated Useful Lives |
|---|---|
| Buildings | 25 years |
| Cable and wire facilities | 20 - 25 years |
| Central office equipment | 15 - 20 years |
| Information origination/termination equipment | 5 - 15 years |
| Communications satellite | 15 years |
| Vehicles and other work equipment | 3 - 10 years |
| Furniture | 3 - 10 years |
| Cellular facilities | 10 years |
| Land improvements | 10 years |

Useful lives, depreciation and amortization method are reviewed periodically to ensure that the periods and method of depreciation and amortization are consistent with the expected pattern of economic benefits from items of property, plant and equipment.

Property under construction is stated at cost. This includes cost of construction, plant and equipment and other direct costs. Property under construction is not depreciated until such time that the relevant assets are completed and put into operational use.

***Borrowing Costs***

Borrowing costs are generally expensed as incurred. Borrowing costs are capitalized if they are directly attributable to the acquisition, construction or production of a qualifying asset. Capitalization of borrowing costs commences when the activities for use are in progress and expenditures and borrowing costs are being incurred. Borrowing costs are capitalized until the assets are ready for their intended use. If the resulting carrying amount of the asset exceeds its recoverable amount, an impairment loss is recorded. Borrowing costs include interest charges and other costs incurred in connection with the borrowing of funds, as well as exchange differences arising from foreign currency borrowings used to finance these projects to the extent that they are regarded as an adjustment to interest cost. Borrowing costs are treated as deductible expenses for income tax reporting purposes in the period they are realized.

***Asset Retirement Obligations***

The net present value of legal obligations associated with the retirement of an item of property, plant and equipment that resulted from the acquisition, construction or development and the normal operation of property, plant and equipment is recognized in the period in which it is incurred.

***Investment Properties***

Initially, investment properties are measured at cost including transaction costs. Subsequent to initial recognition, investment properties are stated at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the consolidated statements of income in the year in which they arise.

Investment properties are derecognized when they have either been disposed of or when the investment property is permanently withdrawn from use and no future benefit is expected from its disposal. Any gains and losses on the derecognition of an investment property are recognized in the consolidated statement of income in the year of derecognition.

***Goodwill***

Goodwill is initially measured at cost being the excess of the acquisition cost over the fair value of identifiable assets, liabilities and contingent liabilities. Following initial recognition, goodwill is measured at cost less any accumulated impairment losses. Upon adoption of PFRS 3, goodwill is no longer amortized. Goodwill is reviewed for impairment, annually or more frequently if events or changes in circumstances indicate that the carrying value may be impaired.

As at acquisition date, any goodwill acquired is allocated to each of the cash-generating units expected to benefit from the combination's synergies. Impairment is determined by assessing the recoverable amount of the cash-generating unit, to which the goodwill relates. Where the recoverable amount of the cash-generating unit is less than the carrying amount, an impairment loss is recognized. Where goodwill forms part of a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the operation disposed of is included in the carrying amount of the operation when determining the gain or loss on disposal of the operation. Goodwill disposed of in such circumstance is measured on the basis of the relative values of the operation disposed of and the portion of the cash-generating unit retained.

***Intangible Assets***

Intangible assets acquired separately are capitalized at cost while those acquired arising from business combinations are initially recognized at fair value as at the date of acquisition. Subsequently, intangible assets are measured at cost. The useful lives of intangible assets are now assessed at the individual asset level as having either a finite or indefinite life. Where an intangible asset has a finite life, it is amortized over its useful life. Periods and method of amortization for intangible assets with finite useful lives are reviewed annually or earlier where an indicator of impairment exists. Intangible assets assessed as having indefinite useful lives are not amortized, as there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the Group. However, intangibles with indefinite useful lives are reviewed annually to ensure the carrying value does not exceed the recoverable amount regardless of whether an indicator of impairment is present.

Gains or losses arising from derecognition of an intangible asset are measured as the difference between the net disposal proceeds and the carrying amount of the asset and are recognized in the consolidated statements of income when the asset is derecognized.

Intangible assets created within the business are not capitalized and expenditure is charged against profits in the year in which the expenditure is incurred.

***Asset Impairment***

Property, plant and equipment, investments, goodwill and other long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Whenever the carrying amount of an asset exceeds its recoverable amount, an impairment loss is recognized in the consolidated statements of income. The recoverable amount is the higher of an asset's net selling price or value in use. The net selling price is the amount obtainable from the sale of an asset in an arm's-length transaction while value in use is the present value of estimated future cash flows expected to arise from the continuing use of an asset or from its disposal at the end of its useful life. Recoverable amounts are estimated for individual assets or, if it is not possible, for the cash-generating unit to which the asset belongs. Reversal of impairment losses recognized in prior years is recorded when there is an indication that the impairment losses recognized for the asset no longer exist or have decreased. The reversal is recorded as income. However, the increased carrying amount of an asset due to a reversal of an impairment loss is recognized to the extent it does not exceed the carrying amount that would have been determined had the impairment loss not been recognized for that asset in prior years.

***Cash and Cash Equivalents***

Cash includes cash on hand and in banks. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash with original maturities of three months or less from the date of acquisition and that are subject to an insignificant risk of change in value.

***Receivables***

Receivables are stated at face value, net of allowance for doubtful accounts.

***Allowance for Doubtful Accounts***

We estimate the allowance for doubtful accounts related to our trade receivables based on two methods. The amounts calculated using each of these methods are combined to determine the total amount we reserve. First, we evaluate specific accounts where we have information that certain customers are unable to meet their financial obligations. In these cases, we use judgment, based on the best available facts and circumstances, including but not limited to, the length of our relationship with the customer and the customer's current credit status based on third party credit reports and known market factors, to record specific reserves for customers against amounts due to reduce our receivable amounts that we expect to collect. These specific reserves are re-evaluated and adjusted as additional information received affects the amounts estimated. Second, a provision is established as a certain percentage of age of status of receivables. This percentage is based on a collective assessment of historical collection, write-off, experience and changes in our customer payment terms. Full allowance is provided for receivables from permanently disconnected subscribers and carriers. Such permanent disconnections generally occur within 105 days from due date. Partial allowance is provided for active subscribers and carriers based on the age status of receivables.

***Inventories and Supplies***

Inventories and supplies which include, among others, cellular phone units, materials, spare parts, terminal units and accessories, are valued at the lower of cost or net realizable value.

Cost is determined using the moving average method. Net realizable value is the current replacement cost.

***Financial Assets and Liabilities***

Financial assets or financial liabilities are recognized initially at fair value. Transaction costs are included in the initial measurement of all financial assets and liabilities, except for financial instruments measured at fair value through profit and loss. Fair value is determined by reference to the transaction price or other market prices. If such market prices are not reliably determinable, the fair value of the consideration is estimated as the sum of all future cash payments or receipts, discounted using the prevailing market rates of interest for similar instruments with similar maturities.

We recognize a financial asset or a financial liability in our consolidated balance sheets when we become a party to the contractual provisions of the instrument and derecognize a financial asset when we no longer control the contractual rights to the cash flows that comprise the financial instrument expires or transferred, which is normally the case when the instrument is sold, or all the cash flows attributable to the instrument are passed through to an independent third party. A financial liability (or a part of a financial liability) is derecognized when the obligation is extinguished. In the case of a regular way purchase or sale of financial assets, recognition and derecognition, as applicable, are done using settlement date accounting.

After initial recognition, the following financial assets and liabilities are measured at amortized cost using the effective interest rate method: (a) loans and receivables; (b) held-to-maturity investments; and (c) financial liabilities other than liabilities measured at fair values through profit and loss.

Investments in unquoted equity securities and derivatives linked thereon are measured at cost.

Amortizations of discounts and premiums are taken directly to net profit or loss for the year. Changes in the fair value of financial assets and liabilities measured at fair value of (a) all derivatives (except for those eligible for hedge accounting); (b) other items intended to be actively traded; and (c) any item designated as held "at fair value through profit and loss" at origination, are taken directly to net profit or loss for the year. Changes in the fair value of available-for-sale securities are recognized in equity, except for the foreign exchange fluctuations on available-for-sale debt securities and the interest component which is taken directly to net profit or loss for the year based on the asset's effective yield.

Financial assets and liabilities include financial instruments which may be a primary instrument, such as receivables, payables and equity securities, or a derivative instrument, such as financial options, futures and forwards, interest rate swaps and currency swaps.

Financial instruments are classified as liabilities or equity in accordance with the substance of the contractual arrangement. Financial instruments that contain both liability and equity elements are classified separately as financial liabilities, financial assets or equity instruments. Interest, dividends, gains and losses relating to a financial instrument or a component that is a financial liability, are reported as expense or income. Distributions to holders of financial instruments classified as equity are charged directly to equity net of any related income tax benefits. Financial instruments are offset when we have a legally enforceable right to offset and we intend to settle either on a net basis or to realize the asset and settle the liability simultaneously.

We use derivative financial instruments such as long-term currency swaps, foreign currency options, interest rate swaps and forward currency contracts to hedge our risks associated with foreign currency and interest rate fluctuations. Such derivative financial instruments are stated at fair value.

Our criteria for a derivative instrument to be classified as a hedge includes: (1) the hedge transaction is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, (2) the effectiveness of the hedge can be reliably measured, (3) there is adequate documentation of the hedging relationships at the inception of the hedge, and (4) for cash flow hedges, the forecast transaction that is subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.

For purposes of hedge accounting, hedges are classified as either fair value hedges where they hedge the exposure to changes in the fair value of a recognized asset or liability and firm commitment; or cash flow hedges where they hedge exposure to variability in cash flows that is either attributable to a particular risk associated with a recognized asset or liability or a forecasted transaction.

In relation to fair value hedges which meet the conditions for special hedge accounting, any gain or loss from re-measuring the hedging instrument at fair value is recognized immediately in the consolidated statements of income. Any gain or loss on the hedged item attributable to the hedged risk is adjusted against the carrying amount of the hedged item and recognized in the consolidated statements of income.

In relation to cash flow hedges, the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge is recognized directly in equity and the ineffective portion is recognized in net profit or loss. The gains or losses that are accumulated in equity are transferred to the consolidated statement of income in the same period in which the hedged item affects the net profit or loss.

For derivatives that do not qualify for hedge accounting, any gains or losses arising from changes in fair value are taken directly to net profit or loss for the year.

Hedge accounting is discontinued when the hedging instrument expires or is sold, terminated or exercised, or no longer qualifies for hedge accounting. At that point in time, any cumulative gain or loss on the hedging instrument recognized in equity is kept in equity until the forecast transaction occurs. If the forecast transaction is no longer expected to occur, any net cumulative gain or loss previously recognized in equity is transferred to net profit or loss for the year.

***Provisions***

We recognize provisions when we have obligations, legal or constructive, as a result of past events, if it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. If the effect of the time value of money is material, provisions are determined by discounting the expected future cash flows at a pre-tax rate that reflects current market assessments of the time value of money and, where appropriate, the risks specific to the liability. Where discounting is used, the increase in the provision due to the passage of time is recognized as an additional provision.

***Retirement Benefits***

We have funded, noncontributory retirement plans, administered by our respective Fund's Trustees, covering permanent employees. Retirement costs are actuarially determined using the projected unit credit of accrued benefit valuation method. This method reflects services rendered by employees to the date of valuation and incorporates assumptions concerning employees' projected salaries. Retirement costs include current service cost plus amortization of past service cost, experience adjustments and changes in actuarial assumptions. Past service cost is recognized as an expense on a straight-line basis over the average period until the benefits become vested. Actuarial gains and losses are recognized as income or expense when the cumulative unrecognized actuarial gains and losses are recognized as income or expense when the net cumulative unrecognized actuarial gains and losses at the end of the previous reporting period exceeded 10% of the higher of the defined benefit obligation and the fair value of plan assets at that date. These gains and losses are recognized over the expected average remaining working lives of the employees participating in the plan.

***Share-Based Payment Transactions***

Certain of our employees (including directors) receive remuneration in the form of share-based payment transactions, whereby employees render services in exchange for shares or rights over shares ("equity-settled transactions").

*Equity-settled transactions*

The cost of equity-settled transactions with employees is measured by reference to the fair value of the stock options at the date at which they are granted. Fair value is determined using an option-pricing model, further details of which are given in *Note 22 - Employee Benefits*. In valuing equity-settled transactions, no account is taken of any performance conditions, other than conditions linked to the price of the shares of PLDT ("market conditions").

The cost of equity-settled transactions is recognized, together with a corresponding increase in equity, over the period in which the performance conditions are fulfilled, ending on the date on which the relevant employees become fully entitled to the award ("vesting date"). The cumulative expense recognized for equity-settled transactions at each reporting date until the vesting date reflects the extent to which the vesting period has expired and the number of awards that will ultimately vest, in the opinion of PLDT's Board of Directors at that date, based on the best available estimate.

No expense is recognized for awards that do not ultimately vest, except for awards where vesting is conditional upon a market condition, which are treated as vesting irrespective of whether or not the market condition is satisfied, provided that all other performance conditions are satisfied.

Where the terms of an equity-settled award are modified, an expense, as a minimum, is recognized as if the terms had not been modified. An expense is recognized for any increase in the value of the transactions as a result of the modification, as measured at the date of modification.

Where an equity-settled award is cancelled, it is treated as if it had vested on the date of cancellation, and any expense not yet recognized for the award is recognized immediately. However, if a new award is substituted for the cancelled award, and designated as a replacement award on the date that it is granted, the cancelled and new awards are treated as if they were a modification of the original award, as described in the previous paragraph.

The dilutive effect of outstanding options is reflected as additional share dilution in the computation of earnings per share, see *Note 7 - Earnings Per Common Share*.

*Cash-settled transactions*

Our Long-term Incentive Plan, or LTIP, grants share appreciation rights, or SARs, to our eligible key executives and advisors. Under the LTIP, we recognize the services we receive from the eligible key executives and advisors, and our liability to pay for those services, as the eligible key executives and advisors render services during the vesting period. We measure our liability, initially and at each reporting date until settled, at the fair value of the SARs, by applying an option valuation model, taking into account the terms and conditions on which the SARs were granted, and the extent to which the eligible key executives and advisors have rendered service to date. We recognize any changes in fair value at each reporting date until settled, in profit and loss for the period.

***Leases***

Lease obligations having provisions for bargain purchase options, ownership transfer at the end of the lease term, or minimum lease payments, which approximate the fair market value of the property are capitalized. The related obligations are recognized as liabilities. Finance lease payments are apportioned between the finance charges and reduction of the lease liability so as to achieve a constant rate of interest on the remaining balance of the liability.

A finance lease gives rise to a depreciation expense for the asset as well as a borrowing cost for each period. Finance charges are charged directly to current operations. The depreciation policy for leased assets is consistent with that for depreciable assets that are owned.

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases. Initial direct costs incurred in negotiating an operating lease are added to the carrying amount of the leased assets and liabilities over the lease term on the same bases as the lease income. Operating lease payments are recognized as an expense in the consolidated statements of income on a straight-line basis over the lease term. For income tax reporting purposes, expenses that should have been incurred under lease agreement are considered as deductible expenses.

***Revenue Recognition***

Revenues for services are stated at amounts invoiced to customers and exclude value-added tax, or VAT. We provide wireless communication services, fixed line communication services, and information and communications technology services. We provide such services to mobile, business, residential and payphone customers. Revenues, which exclude VAT, represent the value of fixed consideration that have been received or are receivable. Revenues are recognized when there is evidence of an arrangement, collectibility is reasonably assured and the delivery of the product or service has occurred.

*Subscriptions*

We provide telephone and data communication services under prepaid and postpaid payment arrangements. Revenues include fees for installation and activation are accrued upon subscription.

*Air time, traffic and value-added services*

Prepaid service revenues collected in advance are deferred and recognized based on the earlier of actual usage or upon expiration of the usage period. Interconnection revenues for call termination, call transit, and network usage are recognized in the period the traffic occurs. Revenues related to local, long distance, network-to-network, roaming and international call connection services are recognized when the call is placed or connection is provided, net of amounts payable to other telecommunication carriers for terminating calls in their territories. Revenues related to products and value-added services are recognized upon delivery of the product or service.

*Cellular handset and equipment sales*

Sales of cellular handsets and communication equipment are recognized upon delivery to the customer.

***Income Taxes***

Deferred income tax is provided, using the balance sheet liability method, on all temporary differences at the balance sheet date between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes.

Deferred income tax liabilities and assets are recognized for all taxable temporary differences. Deferred income tax assets are recognized for all deductible temporary differences, carryforward of unused tax credits from excess minimum corporate income tax, or MCIT, and unused tax losses, to the extent that it is probable that taxable profit will be available against which the deductible temporary differences and carryforward of unused tax credits and unused tax losses can be utilized. Deferred income tax, however, is not recognized when it arises from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither the accounting profit nor taxable profit or loss.

Deferred tax liabilities are not provided on non-taxable temporary differences associated with investments in domestic subsidiaries and associates. With respect to investments in other subsidiaries and associates, deferred tax liabilities are recognized except when the timing of the reversal of the temporary difference can be controlled and it is probable that the temporary difference will not reverse in the foreseeable future.

The carrying amount of deferred income tax assets is reviewed at each balance sheet date and reduced to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred income tax asset to be utilized.

Deferred income tax assets and liabilities are measured at the tax rate that is expected to apply to the period when the asset is realized or the liability is settled, based on tax rate (and tax laws) that have been enacted or substantively enacted at balance sheet date.

Income tax relating to items recognized directly in equity is recognized in equity and not in the consolidated statements of income.

***Earnings Per Common Share, or EPS***

Basic EPS is calculated by dividing the net income or loss for the period attributable to common shareholders (net income or loss adjusted for dividends on all series of preferred shares except for dividends on preferred stock subject to mandatory redemption) by the weighted average number of common shares outstanding during the period, after giving retroactive effect to any stock dividend declarations.

Diluted EPS is calculated in the same manner assuming that, at the beginning of the period or at the time of issuance during the period, all outstanding options are exercised and convertible preferred shares are converted to common shares and appropriate adjustments to net income are effected for the related expenses on preferred shares. Outstanding stock options will have a dilutive effect under the treasury stock method only when the average market price of the underlying common share during the period exceeds the exercise price of the option.

Where the effect of the assumed conversion of the preferred shares and the exercise of all outstanding options have an anti-dilutive effect, basic and diluted EPS are stated at the same amount.

If the required dividends to be declared on each series of convertible preferred shares divided by the number of equivalent common shares, assuming such convertible preferred shares are converted to common shares, would decrease the basic EPS, then such convertible preferred shares would be deemed dilutive. As such, the diluted EPS will be calculated by dividing net income attributable to common shareholders (net income, adding back any dividends and/or other charges recognized in the period related to the dilutive convertible preferred shares classified as liability, less dividends on non-dilutive preferred shares except for dividends on preferred stock subject to mandatory redemption) by the weighted average common shares including the common share equivalent arising from the conversion of the dilutive convertible preferred shares.

## 3. Management's Use of Estimates

Our consolidated financial statements prepared in Philippine GAAP require management to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related notes. In preparing these consolidated financial statements, we have made our best estimates and judgments of certain amounts, giving due consideration to materiality. We believe the following represent a summary of these significant estimates and judgments and related impact and associated risks in our consolidated financial statements.

***Estimating useful lives of property, plant and equipment***

We estimate the useful lives of our property, plant and equipment based on the period over which our assets are expected to be available for use. The estimated useful lives of our property, plant and equipment are reviewed periodically and are updated if expectations differ from previous estimates due to physical wear and tear, technical or commercial obsolescence and legal or other limits on the use of our assets. In addition, our estimation of the useful lives of our property, plant and equipment is based on our collective assessment of industry practice, internal technical evaluation and experience with similar assets. It is possible, however, that future results of operations could be materially affected by changes in our estimates brought about by changes in factors mentioned above. The amounts and timing of recorded expenses for any period would be affected by changes in these factors and circumstances. A reduction in the estimated useful lives of our property, plant and equipment would increase our recorded operating expenses and decrease our noncurrent assets. Property, plant and equipment amounted to Php194,525 million and Php194,790 million as at December 31, 2004 and 2003, respectively.

***Asset impairment***

Philippine GAAP requires that an impairment review be performed when certain impairment indicators are present. In case of goodwill and intangible assets with indefinite life, such assets are subject to yearly impairment test and whenever there is an indication that such asset may be impaired.

Purchase accounting requires extensive use of accounting estimates and judgment to allocate the purchase price to the fair market values of the assets and liabilities purchased, including intangible assets and contingent liabilities. Our business acquisitions have resulted in goodwill, which in the past affected our results of operations for the amount of periodic amortization expense. However, we no longer amortize goodwill under Philippine GAAP effective January 1, 2004. Instead, goodwill is subject to a periodic impairment test.

Determining the fair value of property, plant and equipment, investments and intangible assets, which require the determination of future cash flows expected to be generated from the continued use and ultimate disposition of such assets, requires us to make estimates and assumptions that can materially affect our consolidated financial statements. Future events could cause us to conclude that property, plant and equipment, investments and intangible assets associated with an acquired business is impaired. Any resulting impairment loss could have a material adverse impact on our financial condition and results of operations.

The preparation of the estimated future cash flows involves significant judgment and estimations. While we believe that our assumptions are appropriate and reasonable, significant changes in our assumptions may materially affect our assessment of recoverable values and may lead to future additional impairment charges under Philippine GAAP.

Total goodwill and intangible assets as at December 31, 2004 and 2003 amounted to Php3,864 million and Php372 million, respectively. Total asset impairment amounted to Php1,412 million in 2004, Php5,822 million in 2003 and Php16,713 million in 2002.

***Investment properties***

We have adopted the fair value approach in determining the carrying value of our investment properties. While we have opted to rely on independent appraisers to determine the fair value of our investment properties, such fair value was determined based on recent prices of similar properties, with adjustments to reflect any changes in economic conditions since the date of the transactions that occurred at those prices. The amounts and timing of recorded changes in fair value for any period would differ if we made different judgments and estimates or utilized different basis for determining fair value.

Total investment properties as at December 31, 2004 and 2003 amounted to Php743 million and Php761 million, respectively.

***Deferred tax assets***

We review the carrying amounts at each balance sheet date and reduce deferred tax assets to the extent that it is no longer probable that sufficient taxable profit will be available to allow all or part of the deferred tax assets to be utilized. However, there is no assurance that we will generate sufficient taxable profit to allow all or part of our deferred tax assets to be utilized.

Unrecognized deferred tax assets as at December 31, 2004 and 2003 amounted to Php13,824 million and Php18,958 million, respectively.

***Financial assets and liabilities***

Philippine GAAP requires that we carry certain of our financial assets and liabilities at fair value, which requires extensive use of accounting estimates and judgment. In addition, certain liabilities acquired through debt exchange and restructuring are required to be carried at fair value at the time of the debt exchange and restructuring, see *Note 25 - Financial Assets and Liabilities*. While significant components of fair value measurement were determined using verifiable objective evidence (i.e., foreign exchange rates, interest rates, volatility rates), the amount of changes in fair value would differ if we utilized different valuation methodology. Any changes in fair value of these financial assets and liabilities would affect directly our profit and loss and equity.

The fair value of financial assets and liabilities as at December 31, 2004 amounted to Php46,439 million and Php187,724 million, respectively. Total gain on debt exchange in 2004 amounted to Php4,419 million.

The fair value of financial assets and liabilities as at December 31, 2003 amounted to Php39,681 million and Php211,589 million, respectively. Total gain on debt restructuring in 2003 amounted to Php101 million.

***Estimating allowances for doubtful accounts***

We estimate the allowance for doubtful accounts related to our trade receivables based on two methods. The amounts calculated using each of these methods are combined to determine the total amount we reserve. First, we evaluate specific accounts where we have information that certain customers are unable to meet their financial obligations. In these cases, we use judgment, based on the best available facts and circumstances, including but not limited to, the length of our relationship with the customer and the customer's current credit status based on third party credit reports and known market factors, to record specific reserves for customers against amounts due to reduce our receivable amounts that we expect to collect. These specific reserves are re-evaluated and adjusted as additional information received affects the amounts estimated. Second, a provision is established as a certain percentage of age of status of receivables. This percentage is based on a collective assessment of historical collection, write-off, experience and changes in our customer payment terms. Full allowance is provided for receivables from permanently disconnected subscribers and carriers. Such permanent disconnections generally occur within 105 days from due date. Partial allowance is provided for active subscribers and carriers based on the age status of receivables.

The amounts and timing of recorded expenses for any period would differ if we made different judgments or utilized different estimates. An increase in our allowance for doubtful accounts would increase our recorded operating expenses and decrease our current assets.

Provision for doubtful accounts amounted to Php3,949 million in 2004, Php4,092 million in 2003 and Php4,136 million in 2002. Trade and other receivables, net of allowance for doubtful accounts, amounted to Php10,404 million and Php16,908 million as at December 31, 2004 and 2003, respectively.

***Revenue recognition***

Our revenue recognition policies require us to make use of estimates and assumptions that may affect the reported amounts of our revenues and receivables.

Our agreements with domestic and foreign carriers for inbound and outbound traffic subject to settlements require traffic reconciliations before actual settlement is done, which may not be the actual volume of traffic as measured by us. Initial recognition of revenues are based on our observed traffic adjusted by our normal experience adjustments, which historically are not material in our consolidated financial statements. Differences between the amounts initially recognized and actual settlements are taken up in the accounts upon reconciliation. However, there is no assurance that such use of estimates may not result to material adjustments in future periods.

Revenues under a multiple element arrangement specifically applicable to our wireless business were split into separately identifiable components and recognized when the related components were delivered in order to reflect the substance of the transaction. The fair value of components was determined using verifiable objective evidence. Revenue for handset sales has been quantified and identified separately using the residual value method from our cellular service revenue.

***Pension and other retirement benefits***

The determination of our obligation and cost for pension and other retirement benefits is dependent on our selection of certain assumptions used by actuaries in calculating such amounts. Those assumptions are described in *Note 22 - Employee Benefits* and include among others, discount rates, expected returns on plan assets and rates of compensation increase. In accordance with Philippine GAAP, actual results that differ from our assumptions are accumulated and amortized over future periods and therefore, generally affect our recognized expense and recorded obligation in such future periods. While we believe that our assumptions are reasonable and appropriate, significant differences in our actual experience or significant changes in our assumptions may materially affect our pension and other retirement obligations.

Unrecognized actuarial gain as at December 31, 2004 amounted to Php176 million.

***Contingencies***

We are currently involved in various legal proceedings. Our estimate of the probable costs for the resolution of these claims has been developed in consultation with outside counsel handling our defense in these matters and is based upon an analysis of potential results. We currently do not believe these proceedings will have a material adverse effect on our consolidated financial position. It is possible, however, that future results of operations could be materially affected by changes in our estimates or in the effectiveness of our strategies relating to these proceedings, see *Note 24 - Provisions and Contingencies*.

Outstanding provisions to cover these contingencies amounted to Php4,548 million as at December 31, 2004.

## 4. Segment Information

Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by management in deciding how to allocate resources and in assessing performance. Generally, financial information is required to be reported on the basis that it is used internally for evaluating segment performance and deciding how to allocate resources to segments.

We have organized our business into three main segments:

- Wireless — wireless telecommunications services provided through our cellular service providers, Smart and Piltel, and satellite and VSAT operators, namely PLDT's subsidiaries Mabuhay Satellite, ACeS Philippines and Telesat;
- Fixed Line — fixed line telecommunications services primarily provided through PLDT. We also provide fixed line services through PLDT's subsidiaries Clark Telecom, Subic Telecom, Maratel, Piltel and BCC which together account for approximately 3% of our consolidated fixed lines in service, and PLDT Global; 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; call center services provided by ePLDT's subsidiaries Parlance Systems, Inc., Vocativ Systems, Inc. and ePLDT Ventus, Inc.; internet access and gaming services provided by ePLDT's subsidiary Infocom Technologies, Inc., Digital Paradise, Inc. and netGame, Inc.; and e-commerce and IT-related services provided by other investees of ePLDT, as described in *Note 9 - Investments in Associates - at equity*.

The segment assets and liabilities and results of operations of the segments in 2003 and 2002 have been restated to reflect the effects of the change in accounting policies.

The segment assets as at December 31, 2004, 2003 and 2002 and results of operations of our reportable segments for the years ended December 31, 2004, 2003 and 2002 reported under Philippine GAAP are as follows:

| | Wireless | Fixed Line | Information and Communications Technology | Total |
|---|---|---|---|---|
| | | (in million pesos) | | |
| *As at and for the year ended December 31, 2004* | | | | |
| **Revenues** | | | | |
| External revenues | 78,850 | 45,215 | 2,187 | 126,252 |
| Service | 68,185 | 45,055 | 2,014 | 115,254 |
| Non-service | 6,111 | - | 158 | 6,269 |
| Other income | 4,554 | 160 | 15 | 4,729 |
| Inter-segment revenues | 1,207 | 3,595 | 228 | 5,030 |
| Segment revenues | 80,057 | 48,810 | 2,415 | 131,282 |
| **Result** | | | | |
| Income (loss) before income tax | 31,676 | 1,867 | (623) | 32,920 |
| Provision for income tax | 4,307 | 569 | 72 | 4,948 |
| Net income (loss) for the year | 27,369 | 1,298 | (695) | 27,972 |
| **Assets and liabilities** | | | | |
| Segment assets | 88,971 | 160,153 | 3,603 | 252,727 |
| Investments in associates - at equity | (32,962) | 32,962 | 8 | 8 |
| Total assets | 56,009 | 193,115 | 3,611 | 252,735 |
| Segment liabilities | 58,534 | 155,390 | 1,091 | 215,015 |

**(continued)**

| | Wireless | Fixed Line | Information and Communications Technology | Total |
|---|---|---|---|---|
| | | (in million pesos) | | |
| **Other segment information** | | | | |
| Capital expenditures | 14,742 | 5,903 | 517 | 21,162 |
| Provisions | 417 | 4,431 | (3) | 4,845 |
| Depreciation and amortization | 10,940 | 10,125 | 340 | 21,405 |
| Asset impairment | 430 | 366 | 616 | 1,412 |
| *As at and for the year ended December 31, 2003 (As restated - Note 2)* | | | | |
| **Revenues** | | | | |
| External revenues | 64,814 | 45,851 | 1,618 | 112,283 |
| Service | 53,665 | 45,596 | 1,343 | 100,604 |
| Non-service | 10,548 | - | 166 | 10,714 |
| Other income | 601 | 255 | 109 | 965 |
| Inter-segment revenues | 966 | 1,324 | 275 | 2,565 |
| Segment revenues | 65,780 | 47,175 | 1,893 | 114,848 |
| **Result** | | | | |
| Income (loss) before income tax | 11,277 | (9,140) | (461) | 1,676 |
| Provision for (benefit from) income tax | 1,652 | (2,130) | (67) | (545) |
| Net income (loss) for the year | 9,625 | (7,010) | (394) | 2,221 |
| **Assets and liabilities** | | | | |
| Segment assets | 78,391 | 163,280 | 2,035 | 243,706 |
| Investments in associates - at equity | (21,346) | 22,077 | 449 | 1,180 |
| Total assets | 57,045 | 185,357 | 2,484 | 244,886 |
| Segment liabilities | 57,011 | 174,567 | 686 | 232,264 |
| **Other segment information** | | | | |
| Capital expenditures | 11,589 | 6,377 | 53 | 18,019 |
| Provisions | 160 | 4,597 | 82 | 4,839 |
| Depreciation and amortization | 13,526 | 9,767 | 313 | 23,606 |
| Asset impairment | 2,589 | 2,846 | 387 | 5,822 |
| *As at and for the year ended December 31, 2002 (As restated - Note 2)* | | | | |
| **Revenues** | | | | |
| External revenues | 48,010 | 46,494 | 591 | 95,095 |
| Service | 35,745 | 45,746 | 602 | 82,093 |
| Non-service | 12,095 | - | 50 | 12,145 |
| Other income | 170 | 748 | (61) | 857 |
| Inter-segment revenues | 1,628 | 817 | 423 | 2,868 |
| Segment revenues | 49,638 | 47,311 | 1,014 | 97,963 |
| **Result** | | | | |
| Loss before income tax | 4,015 | 10,789 | 658 | 15,462 |
| Provision for (benefit from) income tax | 359 | 530 | (1) | 888 |
| Net loss for the year | 4,374 | 11,319 | 657 | 16,350 |
| **Assets and liabilities** | | | | |
| Segment assets | 72,189 | 169,702 | 2,530 | 244,421 |
| Investments in associates - at equity | (15,294) | 20,169 | 126 | 5,001 |
| Total assets | 56,895 | 189,871 | 2,656 | 249,422 |
| Segment liabilities | 53,145 | 178,058 | 929 | 232,132 |
| **Other segment information** | | | | |
| Capital expenditures | 7,166 | 9,085 | 653 | 16,904 |
| Provisions | 992 | 3,659 | 45 | 4,696 |
| Depreciation and amortization | 11,041 | 10,623 | 418 | 22,082 |
| Asset impairment | 4,756 | 11,957 | - | 16,713 |

## 5. Revenues and Expenses

***Non-service Revenues***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | (in million pesos) | | |
| Sale of handsets and SIM-packs | **6,111** | 10,548 | 12,095 |
| Point of product sales | **158** | 166 | 50 |
| | **6,269** | 10,714 | 12,145 |

***Other Income***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | (in million pesos) | | |
| Gain on debt exchange and debt restructuring transactions (Note 18) | **4,419** | 101 | 189 |
| Miscellaneous income | **310** | 864 | 668 |
| | **4,729** | 965 | 857 |

***Financing Costs***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | (in million pesos) | | |
| Interest on loans and related items | **12,448** | 13,008 | 14,763 |
| Accretion on financial liabilities - net (Notes 2, 18 and 25) | **3,452** | 2,667 | 2,324 |
| Foreign exchange losses - net (Notes 18 and 26) | **2,699** | 9,359 | 5,970 |
| Hedge costs (Note 25) | **1,011** | 1,054 | 315 |
| Loss (gain) on derivative transactions - net (Notes 2 and 25) | **991** | 525 | (547) |
| Dividends on preferred stock subject to mandatory redemption (Note 17) | **284** | 254 | 240 |
| Financing charges (Note 7) | **146** | 264 | 243 |
| Interest income | **(942)** | (513) | (237) |
| Capitalized interest (Notes 2 and 8) | **(595)** | (887) | (1,343) |
| Capitalized foreign exchange (gains) losses (Notes 2 and 8) | **(74)** | (345) | 38 |
| | **19,420** | 25,386 | 21,766 |

***Compensation and Benefits***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | (in million pesos) | | |
| Salaries and benefits | **10,139** | 11,899 | 9,704 |
| Incentive plans (Note 22) | **660** | 15 | - |
| Manpower rightsizing program, or MRP | **566** | 1,890 | 324 |
| Pension and other benefits (Note 22) | **660** | 1,055 | 998 |
| | **12,025** | 14,859 | 11,026 |

Over the past years, PLDT has been implementing MRP in line with its continuing effort to reduce the cost base of the fixed line business. The MRP cost charged to operations for the years ended December 31, 2004, 2003 and 2002 amounted to Php566 million, Php1,890 million, including a loss on settlement of Php442 million, and Php324 million, primarily representing charges relating to 745, 1,862 and 374 PLDT employees affected by the program, respectively; unrecognized past service costs, which are normally amortized over the estimated remaining average working lives of employees, in respect of employees who availed of the MRP are recognized as loss on settlement. The decision to implement the MRP was anchored on the challenges being faced by the fixed line business as significant changes in technology, increasing competition, and shifting market preferences to cellular use have reshaped the future of the fixed line business. The MRP was implemented under the New Labor Code and is in compliance with all other relevant labor laws and regulations.

***Cost of Sales***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | (in million pesos) | | |
| Cost of cellular handsets and SIM-packs sold | **10,839** | 15,887 | 17,231 |
| Cost of satellite airtime (Notes 21 and 23) | **283** | 207 | 50 |
| | **11,122** | 16,094 | 17,281 |

***Provisions***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | | (in million pesos) | |
| Doubtful accounts (Note 15) | **3,949** | 4,092 | 4,136 |
| Write-down of inventories at net realizable value (Note 16) | **577** | 337 | 560 |
| Onerous contracts (Notes 21 and 23) | **319** | 410 | - |
| | **4,845** | 4,839 | 4,696 |

***Asset Impairment***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | | (in million pesos) | |
| Investments in associates - at equity (Notes 8 and 9) | **1,047** | 1,615 | 20 |
| Property, plant and equipment (Note 8) | **365** | 2,799 | 16,693 |
| Other assets | **-** | 1,408 | - |
| | **1,412** | 5,822 | 16,713 |

***Other Expenses***

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | | (in million pesos) | |
| Operating expenses | **3,425** | 2,330 | 2,389 |
| Equity in net losses of associates | **74** | 79 | 134 |
| Others | **503** | 985 | 3 |
| | **4,002** | 3,394 | 2,526 |

## 6. Income Taxes

The net components of deferred income tax recognized in the consolidated balance sheets are as follows:

| | 2004 | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| Net assets | **12,738** | 10,671 |
| Net liabilities | **(1,943)** | (1,934) |

The components of net deferred tax assets and liabilities are as follows:

| | 2004 | 2003 (As restated - Note 2) |
|---|---|---|
| | | (in million pesos) |
| Net assets | | |
| Unrealized foreign exchange losses | **10,011** | 12,520 |
| Interest charges capitalized | **(4,558)** | (4,766) |
| Allowance for doubtful accounts | **4,068** | 2,959 |
| Unearned revenues | **1,939** | 147 |
| Derivative instruments | **1,798** | 1,331 |
| Foreign exchange differential capitalized | **(1,520)** | (1,642) |
| Unamortized past service cost | **1,130** | 1,146 |
| Preferred stock subject to mandatory redemption | **(1,042)** | (1,748) |
| Pension and other benefits | **761** | 859 |
| Taxes and duties capitalized | **(582)** | (646) |
| Excess of fair value over cost of investment properties | **(106)** | (111) |
| Provisions for unrealized assets | **453** | 451 |
| Write-down of inventories at net realizable value | **190** | 76 |
| Others | **196** | 185 |
| | **12,738** | 10,761 |
| Net liabilities | | |
| Derivative instruments | **(2,938)** | (1,838) |
| Net loss operating carryover, or NOLCO | **1,063** | - |
| Allowance for doubtful accounts | **798** | 565 |
| Unearned revenues | **673** | 388 |
| Foreign exchange differential capitalized | **(644)** | (756) |
| Interest charges capitalized | **(485)** | (555) |
| Unrealized foreign exchange losses | **432** | 580 |
| Write-down of inventories at net realizable value | **203** | 189 |
| Provisions for unrealizable assets | **(1,217)** | (86) |
| Others | **172** | (421) |
| | **(1,943)** | (1,934) |

Provision for (benefit from) income tax consists of:

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | | (in million pesos) | |
| Current | **7,355** | 1,706 | 728 |
| Deferred | **(2,407)** | (2,251) | 160 |
| | **4,948** | (545) | 888 |

The reconciliation between the provision for (benefit from) income tax at the applicable statutory tax rates and the actual provision for (benefit from) income tax follows:

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | | (in million pesos) | |
| Provision for (benefit from) income tax at statutory tax rate | **10,534** | 536 | (4,948) |
| Tax effects of: | | | |
| Income not subject to tax | **(2,213)** | (6,638) | (2,918) |
| Income subject to final tax | **(201)** | (243) | (130) |
| Income subject to lower tax rate | **58** | (49) | (119) |
| Non-deductible expenses | **1,231** | 1,431 | 919 |
| Equity share in net losses of investees including provision for decline in value of investments in associates | **24** | 542 | 43 |
| Write-off (reversal) of deferred income tax assets | **(4,485)** | 3,879 | 8,041 |
| Others | **-** | (3) | - |
| Actual provision for (benefit from) income tax | **4,948** | (545) | 888 |

Mabuhay Satellite and Subic Telecom are registered as Subic Bay Freeport Enterprises while Clark Telecom is registered as a Clark Special Economic Zone Enterprise under R.A. No. 7227, otherwise known as the Bases Conversion and Development Act of 1992, or the Act. As registrants, Mabuhay Satellite, Subic Telecom and Clark Telecom are entitled to all the rights, privileges and benefits established thereunder including tax and duty-free importation of capital equipment and special income tax rate of 5% of gross income, as defined in the Act.

On December 22, 2000, the Philippine Board of Investments, or BOI, approved ePLDT's registration as a new information technology service firm in the field of services related to its internet data center on a pioneer status. As such, ePLDT enjoys, among other incentives, a six-year income tax holiday from January 2001.

On May 3, 2001, the BOI awarded Smart pioneer status for its expansion projects entitling it to a three-year income tax holiday which expired in May 2004. The tax incentive was availed on the basis of incremental income generated from said expansion project. In addition, on July 12, 2001, the BOI awarded Smart pioneer status for its payment infrastructure projects entitling it to enjoy a six-year income tax holiday. In this case, the tax incentive is availed for the entire taxable income of the project.

In 2004 and 2003, tax incentives availed amounted to Php2,208 million and Php6,425 million, respectively.

Smart's deferred income tax assets and liabilities as at December 31, 2004 have been recorded to the extent that such deferred tax assets are expected to be utilized against sufficient future taxable profit.

Certain deferred income tax assets have not been recognized as it is not probable that taxable profits will be sufficient against which they can be utilized. The components of deductible temporary differences for which no deferred tax asset is recognized in the consolidated balance sheets are as follows:

| | **2004** | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | (in million pesos) | |
| Asset impairment | **10,090** | 11,384 |
| Unrealized foreign exchange losses | **1,938** | 1,792 |
| Allowance for doubtful accounts | **746** | 733 |
| Unearned revenues on co-location fees | **470** | 251 |
| MCIT | **305** | 79 |
| NOLCO | **29** | 4,317 |
| Provision for other assets | **133** | 5 |
| Unearned revenues on sale of prepaid cards | **73** | 351 |
| Others | **40** | 46 |
| | **13,824** | 18,958 |

Our consolidated unutilized NOLCO as at December 31, 2004 is detailed as follows:

| **Year Incurred** | **Year Expiring** | **(in million pesos)** |
|---|---|---|
| 2002 | 2005 | 3,329 |
| 2003 | 2006 | 4 |
| 2004 | 2007 | 80 |
| | | 3,413 |
| Tax benefit at 32% | | 1,092 |
| Unrecognized deferred income tax assets as at December 31, 2004 | | (29) |
| | | 1,063 |

## 7. Earnings Per Common Share

The following table presents information necessary to calculate the earnings per common share:

| | **2004** | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | | (in million pesos) | |
| Net income (loss) | **28,044** | 2,123 | (16,353) |
| Less dividends on preferred shares | **1,529** | 1,486 | 1,433 |
| Net income (loss) applicable to common shares | **26,515** | 637 | (17,786) |
| | (in thousands, except per share amounts) | | |
| Outstanding common shares at beginning of year | **169,476** | 169,361 | 168,895 |
| Effect of issuance of common shares during the year | **252** | 52 | 200 |
| Weighted average number of common shares | **169,728** | 169,413 | 169,095 |
| Earnings per common share | **Php156.22** | Php3.76 | (Php105.18) |

The computations of diluted earnings per share were anti-dilutive for the years ended December 31, 2004, 2003 and 2002; therefore, the amounts reported for basic and diluted earnings per share were the same.

### *Dividends Declared*

| Class | Date | | | Amount | |
|---|---|---|---|---|---|
| | Approved | Record | Payable | Per Share | Total |
| | | | | | (in million pesos) |
| **Preferred Shares Subject to Mandatory Redemption** | | | | | |
| Series V | February 19, 2004 | March 17, 2004 | April 15, 2004 | Php4.675 | 12 |
| | June 8, 2004 | June 25, 2004 | July 15, 2004 | 4.675 | 12 |
| | August 3, 2004 | September 2, 2004 | October 15, 2004 | 4.675 | 12 |
| | December 1, 2004 | December 20, 2004 | January 15, 2005 | 4.675 | 10 |
| Series VI | February 19, 2004 | March 17, 2004 | April 15, 2004 | US$0.09925 | 26 |
| | June 8, 2004 | June 25, 2004 | July 15, 2004 | 0.09925 | 27 |
| | August 3, 2004 | September 2, 2004 | October 15, 2004 | 0.09925 | 27 |
| | December 1, 2004 | December 20, 2004 | January 15, 2005 | 0.09925 | 26 |
| Series VII | February 19, 2004 | March 17, 2004 | April 15, 2004 | JP¥10.179725 | 20 |
| | June 8, 2004 | June 25, 2004 | July 15, 2004 | 10.179725 | 20 |
| | August 3, 2004 | September 2, 2004 | October 15, 2004 | 10.179725 | 20 |
| | December 1, 2004 | December 20, 2004 | January 15, 2005 | 10.179725 | 22 |
| Charged to income | | | | | 234 |
| **10% Cumulative Convertible Preferred Stocks** | | | | | |
| Series DD | January 27, 2004 | February 12, 2004 | February 27, 2004 | Php1.00 | 2 |
| Series CC | January 27, 2004 | February 25, 2004 | March 31, 2004 | 1.00 | 17 |
| Series A, I, R, W, AA and BB | June 29, 2004 | July 28, 2004 | August 31, 2004 | 1.00 | 130 |
| Series B, F, Q, V and Z | August 3, 2004 | September 1, 2004 | September 30, 2004 | 1.00 | 91 |
| Series E, K, O and U | October 10, 2004 | October 19, 2004 | October 29, 2004 | 1.00 | 45 |
| Series C, D, J, T and X | October 10, 2004 | October 27, 2004 | November 29, 2004 | 1.00 | 58 |
| Series G, N, P and S | November 10, 2004 | December 1, 2004 | December 29, 2004 | 1.00 | 27 |
| Series H, L, M and Y | December 9, 2004 | December 29, 2004 | January 31, 2005 | 1.00 | 40 |
| | | | | | 410 |
| **Convertible Preferred Stocks** | | | | | |
| Series III | February 19, 2004 | March 17, 2004 | April 15, 2004 | US$1.029412 | 268 |
| | June 8, 2004 | June 25, 2004 | July 15, 2004 | 1.029412 | 267 |
| | August 3, 2004 | September 2, 2004 | October 15, 2004 | 1.029412 | 267 |
| | December 1, 2004 | December 19, 2004 | January 15, 2005 | 1.029412 | 268 |
| | | | | | 1,070 |
| **Cumulative Non-Convertible Redeemable Preferred Stock** | | | | | |
| Series IV* | January 27, 2004 | February 17, 2004 | March 15, 2004 | | 12 |
| | May 4, 2004 | May 26, 2004 | June 15, 2004 | | 12 |
| | August 3, 2004 | August 25, 2004 | September 15, 2004 | | 12 |
| | November 11, 2004 | November 25, 2004 | December 15, 2004 | | 12 |
| Total | | | | | 48 |
| Charged to retained earnings | | | | | 1,528 |

* Dividends are declared based on total amounts, not per share amounts.

### *Proposed Dividend Declaration*

| Class | Date | | | Amount | |
|---|---|---|---|---|---|
| | Approved | Record | Payable | Per Share | Total |
| | | | | | (in million pesos) |
| 10% Cumulative Convertible Preferred Stock - Series DD | January 25, 2005 | February 8, 2005 | February 28, 2005 | Php1.00 | 3 |
| Common Stock | March 1, 2005 | March 31, 2005 | May 12, 2005 | 14.00 | 2,380 |

Retained earnings available for cash dividends amounted to Php10,126 million as at December 31, 2004. Reconciliation of consolidated deficit to Parent Company retained earnings is shown below:

| | (in million pesos) |
|---|---|
| Deficit in the consolidated financial statements | (10,220) |
| Adjustments relating to: | |
| PAS 27 - Consolidated and Separate Financial Statements | 20,269 |
| PAS 36 - Impairment of Assets | (2,025) |
| PAS 40 - Investment Property | 2,102 |
| Retained earnings in the separate financial statements of the Parent Company | 10,126 |

## 8. Property, Plant and Equipment

This account consists of:

| | Cable and wire facilities | Central office equipment | Cellular facilities | Buildings | Vehicles, furniture, and other work equipment | Communications satellite | Information origination/ termination equipment | Land and land improvements | Property under construction | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | (in million pesos) | | | | |
| **At December 31, 2003 (As restated - Note 2)** | | | | | | | | | | |
| Cost | 96,087 | 73,532 | 57,617 | 18,680 | 24,303 | 15,496 | 5,685 | 2,508 | 12,954 | 306,862 |
| Accumulated depreciation, amortization and impairment | (25,175) | (31,097) | (25,669) | (4,237) | (14,220) | (9,079) | (2,246) | (270) | (79) | (112,072) |
| Net book value | 70,912 | 42,435 | 31,948 | 14,443 | 10,083 | 6,417 | 3,439 | 2,238 | 12,875 | 194,790 |
| **Year Ended December 31, 2004** | | | | | | | | | | |
| Net book value - beginning | 70,912 | 42,435 | 31,948 | 14,443 | 10,083 | 6,417 | 3,439 | 2,238 | 12,875 | 194,790 |
| Additions/Transfers - net | 7,277 | 2,127 | 9,516 | 596 | 4,760 | 1,127 | 1,024 | 58 | (2,966) | 23,519 |
| Disposals/Retirement | (134) | (547) | (1,131) | (43) | (67) | - | (43) | (39) | (10) | (2,014) |
| Impairment losses | (127) | (220) | - | - | (6) | - | - | - | (12) | (365) |
| Depreciation and amortization | (5,061) | (3,804) | (7,321) | (824) | (3,155) | (742) | (463) | (35) | - | (21,405) |
| Net book value - end | 72,867 | 39,991 | 33,012 | 14,172 | 11,615 | 6,802 | 3,957 | 2,222 | 9,887 | 194,525 |
| **At December 31, 2004** | | | | | | | | | | |
| Cost | 102,958 | 76,117 | 64,092 | 19,083 | 28,474 | 15,709 | 6,108 | 2,563 | 9,972 | 325,076 |
| Accumulated depreciation, amortization and impairment | (30,091) | (36,126) | (31,080) | (4,911) | (16,859) | (8,907) | (2,151) | (341) | (85) | (130,551) |
| Net book value | 72,867 | 39,991 | 33,012 | 14,172 | 11,615 | 6,802 | 3,957 | 2,222 | 9,887 | 194,525 |

Substantially all our telecommunications equipment are purchased from outside the Philippines. A significant source of financing for such purchases are foreign loans requiring repayment in currencies other than Philippine pesos, principally in U.S. dollars (see *Note 18 - Interest-bearing Financial Liabilities*). Interest, using an average capitalization rate of 7%, and net foreign exchange losses capitalized to property, plant and equipment qualified as borrowing costs for the years ended December 31, 2004, 2003 and 2002 were as follows:

| | **2004** | 2003 | 2002 |
|---|---|---|---|
| | | (As restated - Note 2) | |
| | | (in million pesos) | |
| Interest | **595** | 887 | 1,343 |
| Foreign exchange losses (gains) | **74** | 345 | (38) |

As at December 31, 2004, 2003 and 2002, the undepreciated capitalized net foreign exchange losses qualified as borrowing costs amounted to Php5,528 million, Php6,105 million and Php6,406 million, respectively.

In 2004 and 2003, additional depreciation and amortization charges of Php2,297 million and Php5,251 million, respectively, were recognized due to a change in the estimated useful lives of certain of Smart's network assets owing to continuing network upgrade and expansion.

Asset impairment and retirements recognized in 2004, 2003 and 2002 amounted to Php365 million, Php2,799 million and Php16,693 million, respectively.

In 2004, certain assets with net book values aggregating Php365 million were retired. These assets relate primarily to certain international facility equipment of PLDT Global and Subic Telecom in relation to our strategic direction to functionally integrate our international fixed line business.

In 2003, asset impairment charges and retirements of Php2,799 million mainly consisted of Php974 million asset impairment charges of ACeS Philippines and Php1,438 million impairment charges of Piltel and asset retirements amounting to Php387 million by ePLDT. In June 2003, ACeS Philippines recognized an impairment provision of Php974 million in respect of certain ground equipment in relation to the business of AIL after having determined certain factors which raised substantial doubt about AIL's ability to continue as a going concern. *See Note 9 - Investments in Associates - at equity* for further discussion. Piltel carried out an impairment review on its E.O. 109 fixed wireline network assets (postpaid service) in December 2003. This resulted in an asset impairment charge of Php1,438 million based on the forecasted discounted cash flows from continued use of these assets. The cash flows were discounted at a nominal rate of 8% on a pre-tax basis. In 2003, ePLDT retired certain assets with net book values aggregating Php387 million primarily resulting from the abandonment of a reloadable chip-based cash card project and a change in software platform and selected applications.

In 2002, asset impairment and write-off charges of Php16,713 million were recognized for E.O. 109 and AMPS/CDMA assets of Piltel. Earlier in December 2002, Piltel recognized impairment losses in respect of its AMPS/CDMA and E.O. 109, assets valued at Php4,737 million and Php4,218 million, respectively. For the AMPS/CDMA assets, the impairment resulted from Piltel's decision to deactivate all its AMPS/CDMA cell sites as the revenues generated from its AMPS/CDMA postpaid and prepaid services could no longer support the cost of operating the network. Piltel's revenues from its AMPS/CDMA postpaid and prepaid services declined considerably in 2002 with the sustained success of Piltel's and other cellular operators' prepaid service. The E.O. 109 assets written-off brought down the net book value of these assets to their recoverable value, which was estimated using the net present value of future cash flows from the E.O. 109 postpaid service. Cash flows from the E.O. 109 prepaid or limited mobility service were no longer considered in computing the recoverable value of the E.O. 109 assets as Piltel had terminated this service in February 2003. Revenues from the E.O. 109 prepaid or limited mobility service, which uses N-AMPS cellular technology, were likewise unfavorably affected by the success of Piltel's and other cellular operators' prepaid service. N-AMPS or E.O. 109-limited mobility service assets of Php7,742 million were also written-off in December 2002, with the decommissioning of all the N-AMPS cell sites in February 2003.

Certain property, plant and equipment have been restated to include the following amounts for capitalized leases as at December 31, 2004 and 2003:

| | **2004** | | | 2003 | | |
|---|---|---|---|---|---|---|
| | **Central office equipment** | **Vehicles, furniture and other network equipment** | **Total** | Central office equipment | Vehicles, furniture and other network equipment | Total |
| | | | (in million pesos) | | | |
| Cost | **361** | **863** | **1,224** | 361 | 574 | 935 |
| Less accumulated depreciation | **269** | **410** | **679** | 245 | 153 | 398 |
| | **92** | **453** | **545** | 116 | 421 | 537 |

The following table describes all changes to the asset retirement obligations as at December 31, 2004 and 2003, respectively:

| | **2004** | 2003 |
|---|---|---|
| | | (in million pesos) |
| Asset retirement obligations at beginning of year | **395** | 194 |
| Liability recognition in transition | **177** | 166 |
| Accretion expense | **66** | 35 |
| Asset retirement obligations at end of year | **638** | 395 |

## 9. Investments in Associates - At Equity

This account consists of:

| | **2004** | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| ACeS International Limited (Note 8) | **1,614** | 1,614 |
| Mabuhay Space Holdings Limited | **885** | 885 |
| Stradcom International Holdings, Inc. | **616** | 629 |
| BayanTrade Dotcom, Inc. | **97** | 97 |
| ePDS, Inc. | **6** | 6 |
| Airborne Access Corporation | **2** | 2 |
| Digital Paradise, Inc. (Note 10) | **-** | 34 |
| Ad Tel, Inc. | **-** | 2 |
| | **3,220** | 3,269 |
| Less accumulated impairment | **3,212** | 2,089 |
| Total cost and accumulated impairment and equity losses of associates | **8** | 1,180 |

***Investment of ACeS Philippines in AIL***

As at December 31, 2004, ACeS Philippines has a 20% investment in AIL, a company incorporated under the laws of the island of Bermuda. AIL owns the Garuda I satellite and the related system control equipment in Batam, Indonesia.

In December 1998, AIL and its 95% owned subsidiary, PT Asia Cellular Satellite, entered into an Amended and Restated Credit Agreement, or Amended Agreement, to amend the original Credit Agreement entered into by PT Asia Cellular Satellite and its bank creditors in 1997. Under the Amended Agreement, AIL has, among others, assigned to the banks as collateral all of its tangible properties, including the Garuda Satellite, the system control facilities and system control equipment. On September 30, 2002, PT Asia Cellular Satellite, AIL, as guarantor, P.T. Bank Internasional Indonesia, as security agent, and various banks signed a Rescheduling Agreement, which amended the terms of the Amended and Restated Credit Agreement dated December 29, 1998, moving the principal repayment dates to agreed periods with the final maturity date on January 31, 2012 (see *Note 21 - Related Party Transactions*).

In 2003, AIL has incurred recurring significant operating losses, negative operating cash flows, and significant levels of debt. The financial condition of AIL was partly due to the National Service Providers', or NSPs, inability to generate the amount of revenues originally expected as the growth in subscriber numbers have been significantly lower than budgeted. These factors raise substantial doubt about AIL's ability to continue as a going concern. On this basis, we recognized an impairment provision in respect of our investment in AIL amounting to Php1,614 million.

***Investment of Mabuhay Satellite in Mabuhay Satellite Space Holdings Limited, or MSHL***

In 1996, Mabuhay Satellite entered into a Joint Venture Agreement, or JVA, with Space Systems/Loral Inc., or SS/L, to form MSHL for the purpose of providing high-power Ku-Band satellite transmission services using the payload which was added by SS/L aboard Agila II. Under the terms of the JVA, SS/L is required to convey title to the Additional Payload to MSHL in consideration for SS/L's 35% equity interest in MSHL and Mabuhay Satellite is required to pay SS/L US$19 million for a 65% equity interest in MSHL.

In 2000, SS/L filed a Notice of Default and Termination against Mabuhay Satellite arising from the latter's failure to amicably resolve its unpaid obligation to SS/L under the JVA. In 2002, the arbitration panel handed down its decision and provided for payment by Mabuhay Satellite to SS/L of the principal amount of US$10 million plus accrued interest at 9% per annum. On June 30, 2003, Mabuhay Satellite and SS/L concluded a US$15 million settlement agreement under which Mabuhay Satellite leased two transponders on a life-term basis to SS/L and had offset the lease charges due from SS/L and its receivables from Loral Skynet Network Services, Inc. (formerly known as the Loral Cyberstar, Inc.), among others, for a full and final settlement of the arbitration decision. The agreement was subsequently approved by Mabuhay Satellite's creditors in March 2004.

In accordance with the settlement agreement, Mabuhay Satellite and SS/L shall proceed to dissolve the joint venture under a separate agreement, for which each of the parties shall receive title over such number of transponders owned by the joint venture in proportion to their respective interests. On the basis of the joint venture dissolution, we recognized an impairment provision in respect of our investment in MSHL of Php423 million in 2004.

***Investment in Stradcom International Holdings, Inc., or SIHI***

ePLDT has 22.5% interest in convertible securities of SIHI, the parent company of Stradcom Corporation, which has an existing concession agreement with the Philippine Government for the modernization of the Philippine Land Transportation Office, including the computerization of driver's license issuance, vehicle registration and traffic adjudication systems. SIHI has been incurring losses from the start of operations with recorded capital deficiency since then. On this basis, we recognized an impairment provision in respect of our investment in SIHI of Php616 million in 2004.

***Investment in BayanTrade Dotcom, Inc., or BayanTrade***

BayanTrade was incorporated and registered with the SEC on August 8, 2000 to provide: (a) business-to-business electronic purchasing marketplace to link buyers and suppliers of good services over the Internet; (b) electronic catalogue purchasing facilities over the Internet to buyers and suppliers; (c) link-up with similar horizontal markets and vertical markets across the Asia-Pacific Region and the world; and (d) such facilitating services incidental to the business.

***Investment in ePDS, Inc., or ePDs***

On June 30, 2003, ePLDT signed a Joint Venture Agreement with DataPost Pte Ltd. (DataPost), a subsidiary of Singapore Post, and G3 Worldwide ASPAC (Spring), pursuant to which the parties formed ePDS, a bills printing company which will do laser printing and enveloping services for statements, bills and invoices, and other value-added services to companies in the Philippines. ePLDT has a 50% interest in ePDS, while DataPost has a 30% interest. Spring, the largest international mail services provider, owns the remaining 20%. ePDS has an initial paid-up capital of Php11 million.

***Investment in Airborne Access Corporation, or Airborne Access***

On August 31, 2003, ePLDT signed a Memorandum of Agreement with Airborne Access to acquire a 20% interest at a purchase price of Php2 million. Airborne Access, a pioneering wireless internet service provider, caters primarily to mobile professionals by delivering wireless internet access to its subsidiaries through more than 44 hotspots throughout Metro Manila.

## 10. Business Combinations

***Acquisition of Wolfpac Mobile, Inc., or Wolfpac***

In October 2003, Smart acquired a majority 80% interest in Wolfpac for a total consideration of Php180 million of which Php90 million was paid in 2003 and the balance in April 2004. Prior to the acquisition, Wolfpac (then known as "Wolfpac Communications, Inc.") was one of Smart's leading content providers and the only Philippine content provider to have been nominated twice at the annual GSM Congress for successes in application developments. The acquisition provides Smart with the opportunity to have a direct link to the content development community, a key differentiator in wireless communication service. The purchase consideration has been allocated to the assets and liabilities on the basis of fair values at the date of acquisition.

The fair values of the identifiable acquired assets and liabilities of Wolfpac are as follows:

| | (in million pesos) |
|---|---|
| Property, plant and equipment | 6 |
| Intangible assets - technology applications | 317 |
| Cash and cash equivalents | 7 |
| Receivables | 1 |
| Prepayments and other current assets | 1 |
| | 332 |
| Accounts payable | (3) |
| Deferred income tax liabilities - intangible assets | (101) |
| Due to related parties | (3) |
| | (107) |
| Fair value of net assets | 225 |

Fair value of intangible assets was determined by discounting Wolfpac's cash flows for the next three years from acquisition date at 8% per annum. The net cash outflow on acquisition was Php173 million, representing cash payment of Php180 million and cash acquired from Wolfpac of Php7 million.

***Acquisition of Meridian Telekoms, Inc., or Meridian***

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

The purchase consideration has been allocated to the assets and liabilities on the basis of fair values at the date of acquisition.

| | (in million pesos) |
|---|---|
| Property, plant and equipment | 219 |
| Intangible assets - franchise | 3,638 |
| Cash and cash equivalents | 4 |
| Receivables | 28 |
| Inventories and supplies | 10 |
| Prepayments and other current assets | 14 |
| | 3,913 |
| Accounts payable | (27) |
| Deferred income tax liabilities - intangible assets | (1,164) |
| Due to related parties | (13) |
| Unearned revenues and other liabilities | (86) |
| | (1,290) |
| Fair value of net assets | 2,623 |

Carrying values of current assets and liabilities approximate their realizable values. Property, plant and equipment are stated at replacement cost, net of accumulated depreciation, while fair value of the intangible asset was determined by using comparable market values.

As at December 31, 2004, the net cash outflow on acquisition was Php948 million, representing cash payments of Php1,004 million, cash acquired from Meridian of Php5 million and cost directly related to business combination of Php51 million.

***Acquisition in Digital Paradise, Inc., or Digital Paradise***

As at June 24, 2004, ePLDT has a 67.79% equity interest in Digital Paradise, an internet cafe business which owns and operates the Netopia Internet Cafe chain of stores. ePLDT's investment in debt securities of Netopia Computer Technologies, Inc. (Netopia) amounting to Php24 million as at December 31, 2002 was assigned to Digital Paradise in exchange for a 41% equity interest in Digital Paradise in 2003. As at December 31, 2004, Digital Paradise operates 125 Internet cafe chains nationwide.

ePLDT's subscriptions liability to Digital Paradise as at December 31, 2004, amounted to Php106 million, payable in six equal monthly installments until June 2005.

## 11. Investment Properties

| | **2004** | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| Balance at beginning of year | **761** | 776 |
| Additions (subsequent expenditures) | **3** | 16 |
| Net loss from fair value adjustment | **(21)** | (31) |
| Balance at end of year | **743** | 761 |

Investment properties are stated at fair values, which have been determined based on latest valuations performed by an independent firm of appraisers. The valuation undertaken was based on an open market value, supported by market evidence in which assets could be exchanged between a knowledgeable willing buyer and a knowledgeable willing seller in an arm's-length transaction at the date of valuation, in accordance with international valuation standards.

## 12. Goodwill and Intangible Assets

This account includes intangible assets - technology application arising from the acquisition of Wolfpac and intangible assets - franchise arising from acquisition of Meridian as discussed in *Note 10 - Business Combinations*.

Movements in the goodwill and intangible assets during the years are as follows:

| | **2004** | | | 2003 | | |
|---|---|---|---|---|---|---|
| | **Goodwill** | **Intangible assets** | **Total** | Goodwill | Intangible assets | Total |
| | | | (in million pesos) | | | |
| Cost | **498** | **317** | **815** | 498 | - | 498 |
| Balance at beginning of year | **30** | **3,638** | **3,668** | - | 317 | 317 |
| Additions | **528** | **3,955** | **4,483** | 498 | 317 | 815 |
| Balance at end of year | | | | | | |
| | | | | | | |
| Accumulated amortization and impairment | | | | | | |
| Balance at beginning of year | **(438)** | **(5)** | **(443)** | (402) | - | (402) |
| Additions | **-** | **(176)** | **(176)** | (36) | (5) | (41) |
| Balance at end of year | **(438)** | **(181)** | **(619)** | (438) | (5) | (443) |
| Net balance | **90** | **3,774** | **3,864** | 60 | 312 | 372 |

## 13. Notes Receivable

***Investment of ePLDT in Debt Securities of Technology Support Services, Inc. (formerly First Advance Multi-Media Entertainment Corp., or FAME)***

On June 1, 2004, ePLDT and FAME entered an agreement whereby ePLDT would grant a seven-year non-interest bearing loan to FAME amounting to US$3.1 million. At the option of ePLDT, the loan is convertible into 20% of the total outstanding capital stock of FAME at any time during the life of the outstanding loan.

On August 20, 2004, FAME changed its corporate name into Technology Support Services, Inc., or TSSI.

On September 14, 2004, ePLDT entered into a second agreement with TSSI whereby ePLDT would grant another seven-year non-interest bearing loan to TSSI amounting to US$3.1 million. At the option of ePLDT, the loan is convertible into another 20% of the outstanding capital stock of TSSI at any time during the life of the outstanding loan. As at December 31, 2004, total loan of ePLDT to TSSI amounts to US$5.1 million. The remaining balance of the loan of US$1.1 million would be released to TSSI subject to meeting certain conditions.

ePLDT has not yet converted its investment in debt securities to TSSI's shares of stock as at December 31, 2004. TSSI would be the systems integrator for the internet and mobile telephone gaming project.

The fair value of the debt instrument was computed as the present value of estimated future cash flows. The cost of the instrument approximates the fair value computed as at December 31, 2004.

## 14. Cash and Cash Equivalents

This account consists of:

| | 2004 | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| Cash on hand and in banks | **4,750** | 2,736 |
| Temporary investments | **22,571** | 16,636 |
| | **27,321** | 19,372 |

Cash in banks earns interest at prevailing bank deposit rates. Temporary investments are made for varying periods of up to two months depending on our immediate cash requirements, and earn interest at prevailing short-term deposit rates. Due to the short-term nature of such transactions, the carrying value approximates the fair value of our temporary investments.

## 15. Trade and Other Receivables

This account consists of receivables from:

| | 2004 | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| Customers and carriers | **27,280** | 30,245 |
| Others | **1,192** | 877 |
| | **28,472** | 31,122 |
| Less allowance for doubtful accounts | **18,068** | 14,214 |
| | **10,404** | 16,908 |

Receivables from carriers represent receivables arising from interconnection agreements with other telecommunications carriers. The aforementioned receivable balances are shown net of related payables to the same telecommunications carriers because an established right of offset exists.

On October 10, 2002, PLDT entered into a Receivables Purchase Deed, or RPD, with a foreign financial institution, or the Purchaser, under which PLDT agreed (1) to sell its receivables from certain eligible foreign carriers for an advance payment of US$50 million, of which, US$28 million remains outstanding as at December 31, 2004, and (2) to service, administer and collect the receivables on behalf of the Purchaser. Under the RPD, the Purchaser has no recourse to PLDT should an eligible carrier fail or refuse to settle the assigned/purchased receivables, except when PLDT commits a breach of its representations and warranties under the RPD.

Sale of receivables under the RPD amounted to US$10 million (Php576 million) and US$11 million (Php616 million) for the years ended December 31, 2004 and 2003, respectively. Loss on sale of receivables under the RPD amounted to US$1 million (Php75 million) and US$2 million (Php86 million) for the years ended December 31, 2004 and 2003, respectively.

## 16. Inventories and Supplies

This account consists of:

| | 2004 | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| Terminal and cellular phone units: | | |
| At net realizable value | **1,357** | 1,112 |
| At cost | **1,895** | 1,601 |
| Spare parts and supplies: | | |
| At net realizable value | **389** | 1,078 |
| At cost | **985** | 1,318 |
| Others (At cost) | **394** | 486 |
| | **2,140** | 2,676 |

## 17. Equity

The movement of PLDT's capital account follows:

| | **Preferred Stock** - Php10 par value | | | | | **Common Stock** - Php5 par value | |
|---|---|---|---|---|---|---|---|
| | **Series A to EE** | **III** | **IV** | | | | |
| | | **No. of Shares** | | **Total Preferred Stock** | **Amount** | **No. of Shares** | **Amount** |
| | | | | (in million shares and pesos) | | | |
| **Authorized** | | | | 823 | Php8,230 | 234 | Php1,170 |
| **Outstanding** | | | | | | | |
| Balance at January 1, 2002 | 372 | 5 | 36 | 413 | Php4,129 | 168 | Php845 |
| Issuance | 37 | - | 7 | 44 | 440 | - | - |
| Conversion | (3) | - | - | (3) | (23) | 1 | 2 |
| Redemption | - | - | (7) | (7) | (72) | - | - |
| Balance at December 31, 2002 (As restated - Note 2) | 406 | 5 | 36 | 447 | Php4,474 | 169 | Php847 |
| Balance at January 1, 2003 | 406 | 5 | 36 | 447 | Php4,474 | 169 | Php847 |
| Issuance | 5 | - | - | 5 | 52 | - | - |
| Conversion | (1) | - | - | (1) | (21) | - | - |
| Balance at December 31, 2003 (As restated - Note 2) | 410 | 5 | 36 | 451 | Php4,505 | 169 | Php847 |
| Balance at January 1, 2004 | 410 | 5 | 36 | 451 | Php4,505 | 169 | Php847 |
| Issuance | 1 | - | - | 1 | 9 | - | 2 |
| Conversion | (2) | - | - | (2) | (17) | 1 | 2 |
| Balance at December 31, 2004 | 409 | 5 | 36 | 450 | Php4,497 | 170 | Php851 |

***Preferred Stock***

The preferred stock is non-voting, except as specifically provided by law, and is preferred as to liquidation.

The Series A to EE 10% Cumulative Convertible Preferred Stocks earn cumulative dividends at an annual rate of 10%. After the lapse of one (1) year from the last day of the year of issuance of a particular series of 10% Cumulative Convertible Preferred Stock, any holder of such series may convert all or any of the shares of 10% Cumulative Convertible Preferred Stock held by him into fully paid and non-assessable shares of Common Stock of PLDT, at a conversion price equivalent to 10% below the average of the high and low daily sales price of a share of Common Stock on the PSE, or if there shall have been no such sales on the PSE on any day, the average of the bid and the asked prices of a share of Common Stock of PLDT at the end of such day on such Exchange, in each such case averaged over a period of thirty (30) consecutive trading days prior to the conversion date, but in no case shall the conversion price be less than the price set by the Board of Directors which as at December 31, 2004, was Php5.00 per share. The number of shares of Common Stock issuable at any time upon conversion of one share of SIP Cumulative Convertible Preferred Stock shall be determined by dividing Php10.00 by the then applicable conversion price.

In case the shares of Common Stock at anytime outstanding shall be subdivided into a greater or consolidated into a lesser number of shares, then the minimum conversion price per share of Common Stock shall be proportionately decreased or increased, as the case may be and in the case of a stock dividend, such price shall be proportionately decreased, provided, however, that in every case the minimum conversion price shall not be less than the par value per share of Common Stock. In the event the relevant effective date for any such subdivision or consolidation of shares or stock dividend occurs during the period of thirty (30) trading days preceding the presentation of any shares of 10% Cumulative Convertible Preferred Stock for conversion, a similar adjustment shall be made in the sales prices applicable to the trading days prior to such effective date utilized in calculating the conversion price of the shares presented for conversion.

In case of any other reclassification or change of outstanding shares of Common Stock, or in case of any consolidation or merger of PLDT with or into another corporation, the Board of Directors shall make such provisions, if any, for adjustment of the minimum conversion price and the sales price utilized in calculating the conversion price as the Board of Directors, in it sole discretion, shall deem appropriate.

At PLDT's option, the Series A to EE 10% Cumulative Convertible Preferred Stock are redeemable at par value plus accrued dividends five years after the year of issuance.

On January 27, 2004, the Board of Directors designated 1 million shares of serial preferred stock as Series EE 10% Cumulative Convertible Preferred Stock for issuance throughout 2004.

On December 9, 2004, the Board of Directors designated 500,000 shares of serial preferred stock as series FF 10% Cumulative Convertible Preferred Stock for issuance throughout 2005.

The Series III Convertible Preferred Stock earns cumulative dividends at an annual rate of US$3.50 a share payable quarterly, free and clear of Philippine withholding taxes. It is convertible into Common Stock at the option of the holder at any time, at the conversion price of US$29.19 per Common Stock (equivalent to a conversion ratio of 1.7129 shares of Common Stock for each share of Series III Convertible Preferred Stock, each share of Series III Convertible Preferred Stock being valued for this purpose at its reference amount of US$50 a share), subject to adjustment in certain events; and are not redeemable. Upon liquidation of PLDT, holders of the Series III Convertible Preferred Stock will be entitled to receive liquidating distributions equivalent to Php11 per share, plus accrued and unpaid dividends to the date of distribution, subject to the prior rights of creditors.

The Series IV Cumulative Non-Convertible Redeemable Preferred Stock earns cumulative dividends at an annual rate of 13.5% based on the paid-up subscription price. It is redeemable at the option of PLDT at any time one year after subscription and at the actual amount paid for such stock, plus accrued dividends. On February 26, 2002, the Board of Directors called for the payment of a portion of the balance of the subscription price of the Series IV Cumulative Non-Convertible Redeemable Preferred Stock amounting to Php72 million, which was paid on March 5, 2002. On March 22, 2002, PLDT redeemed 60 million shares out of the 360 million subscribed shares of its Series IV Cumulative Non-Convertible Preferred Stock and paid Php72 million, representing the redemption price plus unpaid dividends up to the date of redemption.

The provisions of certain subscription agreements involving preferred stock have an effect on the ability of PLDT to, without written consent, sell certain assets and pay cash dividends unless all dividends for all past quarterly dividend periods have been paid and provision has been made for the currently payable dividends.

## 18. Interest-bearing Financial Liabilities

| | 2004 | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| **Long-term Portion of Interest-bearing Financial Liabilities** | | |
| Long-term debt | **121,012** | 152,646 |
| Obligations under capital lease (Note 8) | **601** | 729 |
| Preferred stock subject to mandatory redemption | **14,375** | 12,735 |
| | **135,988** | 166,110 |
| **Interest-bearing Financial Liabilities Maturing Within One Year** | | |
| Notes payable: | | |
| Bank loans | **58** | 200 |
| Commercial paper | **-** | 1,933 |
| Obligations under capital lease maturing within one year (Note 8) | **425** | 295 |
| Long-term debt maturing within one year | **28,018** | 23,810 |
| | **28,501** | 26,238 |

Unamortized debt discount, representing debt issuance costs and any difference between the fair value of consideration given or received on initial recognition, included in following financial liabilities are as follows:

| | 2004 | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| Long-term debt | **10,440** | 7,904 |
| Obligations under capital lease (Note 8) | **741** | 714 |
| Preferred stock subject to mandatory redemption | **6,182** | 7,772 |
| Total unamortized debt discount | **17,363** | 16,390 |

The following table describes all changes to unamortized debt discount as at December 31, 2004 and 2003.

| | 2004 | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | | (in million pesos) |
| Unamortized debt discount at beginning of year | **16,390** | 17,416 |
| Additions during the year (Note 18) | **7,765** | 91 |
| Accretion during the year charged to financing cost (Note 5) | **(3,452)** | (2,667) |
| Revaluations | **474** | 1,595 |
| Settlement during the year (Note 18) | **(3,814)** | (45) |
| Unamortized debt discount at end of year | **17,363** | 16,390 |

### *Long-Term Debt*

| Description | Interest Rates | 2004 | | 2003 (As restated - Note 2) | |
|---|---|---|---|---|---|
| | | (in millions) | | | |
| *U.S. Dollars* | | | | | |
| Export Credit Agencies-Supported Loans: | | | | | |
| Kreditanstalt für Wiederaufbau, or KfW | 5.65% - 8.03% and US$ LIBOR + 0.55% - 2.5% | **US$351** | **Php19,793** | US$398 | Php22,099 |
| Finnish Export Credit or Finnvera | 6.36% - 7.75% and US$ LIBOR + 1.30% - 1.425% | **159** | **8,964** | 242 | 13,427 |
| Nippon Export and Investment Insurance of Japan, or NEXI | US$ LIBOR +1% | **74** | **4,179** | 58 | 3,218 |
| Japan Bank for International Cooperation, or JBIC/Co-financing Banks | 6.56% - 7.95% and US$ LIBOR + 0.65% - 1.55% | **44** | **2,459** | 66 | 3,644 |
| Others | 5.83% - 7.89% and US$ LIBOR + 0.15% - 4.30% and CXC's cost + 0.20% | **104** | **5,871** | 146 | 8,116 |
| | | **US$732** | **Php41,266** | US$910 | Php50,504 |
| Fixed Rate Notes | 7.85% - 11.375% | **1,220** | **68,795** | 1,401 | 77,880 |
| Term Loans: | | | | | |
| Debt Exchange Facility | 2.25% and US$ LIBOR + 1% | **155** | **8,721** | - | - |
| GSM Network Expansion Facilities | 4.49% and US$ LIBOR + 3.25% | **125** | **7,046** | 30 | 1,682 |
| Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V., or FMO | US$ LIBOR + 1.95% - 2.05% | **51** | **2,862** | 75 | 4,161 |
| Multi-currency Term Loan | US$ LIBOR + 3.65% | **-** | **-** | 52 | 2,872 |
| Others | 5.83% and LIBOR + 0.40% - 3.625% | **33** | **1,863** | 42 | 2,364 |
| Restructured Loans | 3M US$ LIBOR + 1% | **85** | **4,815** | 132 | 7,310 |
| Satellite Acquisition Loans | US$ LIBOR + 1.75% and 5.6% | **72** | **4,064** | 85 | 4,722 |
| | | **US$2,473** | **Php139,432** | US$2,727 | Php151,495 |
| *Japanese Yen* | | | | | |
| JBIC's Overseas Investment Loan, or OIL | 2.125% | **JP¥9,760** | **5,363** | JP¥9,760 | 5,068 |
| Export Credit Agency-Supported Loan: NEXI, Supported Loan | JP¥ LIBOR + 1.70% | **2,205** | **1,212** | - | - |
| Multi-currency Term Loan | JP¥ LIBOR + 3.85% | **-** | **-** | 10,566 | 5,487 |
| Restructured Loans | JP¥ LIBOR + 1% | **-** | **-** | 13,407 | 6,963 |
| | | **JP¥11,965** | **6,575** | JP¥33,733 | 17,518 |
| *Philippine Pesos* | | | | | |
| Peso Fixed Rate Corporate Notes | 14% - 15.816% | **-** | **1,675** | - | 2,173 |
| Term Loans: | | | | | |
| JBIC 4 Program | 11.18% | **-** | **680** | - | 1,284 |
| Secured Term Loans | 11.6% - 24% and 91-day T-Bill + 4% and 90-day PHIBOR + 3% | **-** | **305** | - | 130 |
| Other Unsecured Term Loans | 12.81% - 17.5% | **-** | **-** | - | 542 |
| Restructured Loans | 90-day T-Bill + 1% | **-** | **363** | - | 3,314 |
| | | **-** | **3,023** | - | 7,443 |
| | | | **149,030** | | 176,456 |
| Less portion maturing within one year | | | **28,018** | | 23,810 |
| Total long-term debt | | | **Php121,012** | | Php152,646 |

Note: Amounts presented are net of unamortized debt discount and debt issuance cost.

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

| | U.S. Dollar Loans | | JP¥ Loans | | Php Loans | Total |
|---|---|---|---|---|---|---|
| | In U.S. Dollar | In Php | In JP¥ | In Php | In Php | In Php |
| | | | (in millions) | | | |
| **Year** | | | | | | |
| 2005 | 448 | 25,282 | 3,420 | 1,879 | 870 | 28,031 |
| 2006 | 410 | 23,131 | 3,418 | 1,878 | 852 | 25,861 |
| 2007 | 487 | 27,439 | 3,418 | 1,879 | 78 | 29,396 |
| 2008 | 100 | 5,583 | 1,709 | 939 | 67 | 6,589 |
| 2009 | 251 | 14,137 | - | - | 56 | 14,193 |
| 2010 and onwards | 962 | 54,186 | - | - | 1,214 | 55,400 |

*U.S. Dollar loans*

*Export Credit Agencies-Supported Loans*

In order to obtain imported components for our network infrastructure in connection with our expansion and service improvement programs, we have obtained loans extended and/or guaranteed by various export credit agencies. These financings account for a significant portion of our indebtedness.

*Kreditanstalt für Wiederaufbau, or KfW*

KfW, a German state-owned development bank, is PLDT's largest single creditor. As at December 31, 2004, we owed US$351 million aggregate principal amount of debt to KfW, as follows:

- US$262 million provided under various export credit agency-backed facilities, of which US$152 million was in connection with our expansion and service improvement programs and US$110 million in connection with the US$149 million refinancing facility discussed below; and
- US$89 million provided for the 15% downpayment portion and credit facilities without guarantee/insurance cover from the export credit agencies, of which US$30 million was in connection with the US$149 million refinancing facility discussed in the following paragraphs.

On January 25, 2002, PLDT signed two loan agreements with KfW, which provided PLDT with a US$149 million facility to refinance in part the repayment installments under its existing loans from KfW due from January 2002 to December 2004. The facility is composed of a nine-year loan, inclusive of a three-year disbursement period and a two-year grace period during which no principal is payable. It partly enjoys the guarantee of HERMES, the export credit agency of the Federal Republic of Germany. We have drawn US$140 million (Php7,885 million) under this facility as at December 31, 2004. PLDT waived further disbursements under this refinancing facility effective September 1, 2004. Thus, the undrawn portion of US$9 million was cancelled.

Of the amounts outstanding under these KfW loans, US$83 million of our KfW loans will mature in 2005, US$57 million in 2006, US$78 million in 2007, US$58 million in 2008, US$44 million in 2009 and US$31 million in 2010. Principal amortization on these loans is generally payable in equal semi-annual installments.

*Finnish Export Credit, plc or Finnvera*

As at December 31, 2004, US$162 million aggregate principal amount of Smart's debts provided by various banks under export credit agency-backed facilities in connection with Smart's Phases 1, 2, 3, 4, part of 5A and 5B GSM expansion programs are covered by guarantees from Finnvera, the Finnish export credit agency, for 95% of political risk and 50% of commercial risk.

Of the amounts outstanding under these Finnvera guaranteed loans, US$95 million will mature in 2005 and US$67 million will mature in 2006. Principal amortization on these loans is generally payable in equal semi-annual installments.

*Nippon Export and Investment Insurance of Japan, or NEXI*

On November 28, 2002, Smart signed a US$100 million term loan facility supported by NEXI of which US$60 million was drawn on November 28, 2003 and US$40 million on April 5, 2004. This loan is payable semi-annually over four years in eight equal installments starting May 28, 2004 with final repayment due in November 2007. Outstanding balance as at December 31, 2004 is US$75 million.

*Japan Bank for International Cooperation, or JBIC/Co-financing Banks*

As at December 31, 2004, PLDT owed US$44 million aggregate principal amount of debt to JBIC (formerly the Export-Import Bank of Japan) and its co-financing banks under various facilities. Of the amounts outstanding under these loans, US$14 million will mature in 2005, US$13 million in 2006, US$10 million in 2007, US$4 million in 2008 and US$3 million in 2009.

*Other Export Credit Agency Supported Loans*

PLDT has also obtained loans extended and/or guaranteed by other export credit agencies, including the Export-Import Bank of the United States, and the respective export credit agencies of France, Italy, Israel, Sweden, Denmark, Canada, Australia, the United Kingdom and Singapore, in the aggregate outstanding principal amount of US$104 million as at December 31, 2004. Smart, likewise, obtained loans guaranteed by export credit agencies of Norway and Italy amounting to US$8 million. Of the amounts outstanding under these loans, US$40 million will mature in 2005, US$33 million in 2006, US$24 million in 2007, US$4 million in 2008, US$2 million in 2009 and US$1 million in 2010.

*Fixed Rate Notes*

PLDT has the following non-amortizing fixed rate notes outstanding as at December 31, 2004 and 2003:

| Principal Amount | Interest Rate | Maturity Date | 2004 | | 2003 (As restated - Note 2) | |
|---|---|---|---|---|---|---|
| | | | (in millions) | | | |
| US$300,000,000 | 8.350% | March 6, 2017 | **US$296** | **Php16,658** | US$294 | Php16,362 |
| US$250,000,000 | 11.375% | May 15, 2012 | **242** | **13,661** | 243 | 13,511 |
| US$183,913,000 | 7.850% | March 6, 2007 | **183** | **10,315** | 199 | 11,090 |
| US$175,000,000 | 10.500% | April 15, 2009 | **174** | **9,777** | 174 | 9,663 |
| US$129,827,000 | 9.250% | June 30, 2006 | **129** | **7,289** | 175 | 9,702 |
| US$110,557,000 | 9.875% | August 1, 2005 | **110** | **6,223** | 138 | 7,675 |
| US$ 88,263,000 | 10.625% | May 15, 2007 | **86** | **4,872** | 98 | 5,438 |
| US$ 77,002,000 | 10.625% | June 2, 2004 | - | - | 77 | 4,278 |
| | | | **US$1,220** | **Php68,795** | US$1,398 | Php77,719 |

*Term Loans*

*US$283 Million Term Loan Facility (Debt Exchange Facility)*

On July 2, 2004, Smart acquired from Piltel's creditors approximately US$289 million, or 69.4%, in the aggregate of the outstanding restructured Piltel debt, in exchange for Smart debt. Smart paid cash of US$1.5 million (Php84 million) and issued new debt of US$283.3 million at fair value of Php8,390 million, net of debt discount amounting to Php7,464 million. As at December 31, 2004, unamortized discount amounted to Php7,238 million.

The breakdown of the total amount of Smart debt issued to participating Piltel creditors are as follows:

- 2007 Facility for US$0.2 million payable in full in December 2007;
- 2008 Facility for US$2.9 million payable in full in December 2008; and
- 2014 Facility for US$280.1 million payable in full in June 2014.

Interest for the above facilities is payable every quarter at a floating rate of three months US$ LIBOR plus 1.00% for the 2007 and 2008 facilities, and a fixed rate of 2.25% per annum for the 2014 facility. Furthermore, a portion of the 2014 facility amounting to US$144 million has a variable yield option whereby the creditor has an option to elect for an early repayment at a discount either in December 2007 at 52.5% of the relevant debt amount or in December 2008 at 57.5% of the relevant debt amount.

*GSM Network Expansion Facilities*

On September 13, 2004, Smart signed a US$104 million 5-year term loan facility supported by Finnish Export Credit PLc as the lender with ABN AMRO Bank, Banque National de Paribas, Calyon, DBS Bank and Sumitomo Mitsui Banking Corporation as the Lead Arrangers. The full amount of the facility was drawn in November 2004. The loan will be payable over five years in ten equal payments starting May 2005 with final repayment in November 2009.

On June 8, 2001, Smart signed its GSM Phase 5A financing comprised of US$195 million loans, of which US$30 million is owed to Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V., or FMO, of the Netherlands, US$15 million to Nordic Investment Bank and US$150 million to Finnvera. Of the amounts owed to FMO and Nordic Investment Bank, US$22 million remained outstanding as at December 31, 2004, are payable over five to six years, with final repayments due in March 2007 and June 2007.

*Local Exchange Transfer Loans*

In connection with the transfer to PLDT of Smart's local exchange business, PLDT entered into loan agreements with Nederlandse Financierings-Maatschappij Voor Ontwikkelingslanden N.V., or FMO, of the Netherlands, Exportkreditnamden, or EKN, of Sweden and Export Credits Guarantee Department, or ECGD, of the United Kingdom for loans in the principal amounts of US$135 million, US$36 million and US$27 million, respectively. Approximately US$51 million of the FMO loan and US$25 million of the EKN and ECGD loans were outstanding as at December 31, 2004. The FMO loan will mature on September 1, 2007, and the EKN and ECGD loans on December 31, 2007.

*Multi-currency Refinancing Facility*

On September 4, 2002, PLDT signed a loan agreement with a syndicate of banks for a US$145 million multi-currency term loan facility consisting of Japanese yen and U.S. dollar commitments of JP¥10,914 million and US$53 million, respectively. This facility was split into two tranches. Tranche A was drawn on June 18, 2003 in the amount of JP¥7,723 million and US$34 million to refinance a portion of the Japanese yen syndicated term loan which matured on the same date. Tranche B was drawn on December 22, 2003 in the amount of JP¥3,191 million and US$19 million to refinance a portion of US$52 million principal amount outstanding under the U.S. dollar term loan which matured on the same date. The outstanding balances of Tranches A and B of this multi-currency term loan amounting to US$36 million and JP¥7,276 million originally with final maturity in December 2006 were prepaid on December 20, 2004.

*Restructured Loans*

On June 4, 2001, Piltel completed the restructuring of approximately Php41 billion of indebtedness and other claims owed to banks, trade creditors, bondholders and preferred shareholders, representing 98% of its total liabilities as at that date.

As a result of the restructuring:

a. 50% of the financial debt of each participating creditor was released in consideration for the allotment of Piltel Series K Class I Convertible Preferred Stock. One (1) Piltel Series K Class I Convertible Preferred Stock was exchanged for every Php340 worth of debt for which it is being exchanged (converted into Pesos at an exchange rate of Php47.05 = US$1.00 for dollar-denominated debt and Php1.00 = JP¥2.39522 for yen-denominated debt), which shares were immediately and mandatorily converted into PLDT Convertible Preferred Stock. One PLDT Series V, VI or VII convertible preferred share was issued for every five (5) Piltel Series K Class I Convertible Preferred Stock.

b. Approximately half of the remaining 50% of all participating creditors' (except for bondholders and preferred shareholders) financial debt became their participation in a Tranche B Loan in the same currency as their previous financial debt and the other half became their participation in a Tranche C Loan also in the same currency as their previous financial debt. In the case of bondholders and preferred shareholders, the remaining 50% of their financial debt became a participation in the Conversion Notes Facility and in a single Tranche Peso loan (the Term Notes Facility), respectively.

On July 2, 2004, Smart acquired from Piltel's creditors US$289 million or 69.4% of Piltel's total outstanding restructured debt at that time, in exchange for US$283.3 million in new debt of Smart and US$1.5 million in cash. A gain on debt exchange transaction amounting to Php4,419 million was recognized in our consolidated statement of income representing the difference between the fair value of Piltel's debt cancelled and/or exchanged for a cash and Smart's debt amounting to Php12,893 million (net of debt discount of Php3,359 million) and Smart's consideration for the debt exchange including cash of Php84 million (US$1.5 million) and fair value of newly issued debt amounting to Php8,390 million (net of debt discount of Php7,464 million). This portion of Piltel's debt has been eliminated in consolidation as at December 31, 2004.

Piltel's residual long-term debt to third parties consists of:

| Description | **2004** | | 2003 (As restated - Note 2) | |
|---|---|---|---|---|
| | (in millions) | | | |
| **Restructured debts** | | | | |
| Philippine Pesos | | | | |
| 10 year Tranche B | | **Php241** | | Php2,166 |
| 15 year Tranche C | | **241** | | 2,166 |
| 15 year Term Notes Facility | | **-** | | 294 |
| | | **482** | | 4,626 |
| U.S. Dollars | | | | |
| 10 year Tranche B | **US$10** | **548** | US$35 | 1,932 |
| 15 year Tranche C | **10** | **548** | 35 | 1,932 |
| 15 year Conversion Notes Facility | **99** | **5,606** | 122 | 6,768 |
| | **US$119** | **6,702** | US$192 | 10,632 |
| Japanese Yen | | | | |
| 10 year Tranche B | **JP¥** | **-** | JP¥7,822 | 4,062 |
| 15 year Tranche C | **-** | **-** | 7,822 | 4,062 |
| | **JP¥** | **-** | JP¥15,644 | 8,124 |
| Total | | **7,184** | | 23,382 |
| Less unamortized discount (Note 2) | | **2,006** | | 5,796 |
| | | **5,178** | | 17,586 |
| **Unrestructured debt** | | | | |
| U.S. Dollars | | | | |
| Convertible bonds | **US$1** | **52** | US$1 | 51 |
| Total | | **5,230** | | 17,637 |
| Less current portion | | **59** | | 69 |
| | | **Php5,171** | | Php17,568 |

The following is a summary of the key economic terms relating to the restructuring of the financial debt taking the form of Tranche B Loan, Tranche C Loan, Term Notes Facility and Conversion Notes Facility.

| | **Tranche B Loans** | **Tranche C Loans** | **Term Notes Facility** | **Conversion Notes Facility** |
|---|---|---|---|---|
| Final maturity | 10 years from June 4, 2001 | 15 years from June 4, 2001 | 15 years plus 10 days from June 4, 2001 | 15 years from June 4, 2001 |
| Amortization | Years 1 and 2 - 0.00%<br>Years 3 to 9 - 0.10%<br>Year 10 - 99.30% | Years 1 and 2 - 0.00%<br>Years 3 and 4 - 0.10%<br>Year 5 - 2.00%<br>Years 6 to 14 - 10.00%<br>Year 15 - 7.80% | Years 1 and 2 - 0.00%<br>Years 3 to 14 - 0.10%<br>Year 15 - 98.80% | Years 1 and 2 - 0.00%<br>Years 3 and 4 - 0.10%<br>Year 5 - 1.05%<br>Years 6 to 9 - 5.05%<br>Year 10 - 54.65%<br>Years 11 to 14 - 5.00%<br>Year 15 - 3.90% |
| Interest rate | **Peso facility** - Philippines 91-day treasury bill rate, or T-Bill Rate, or the average of the 91-day T-Bill Rate and the 90-day Philippine inter-bank offered rate, or PHIBOR, if 90-day PHIBOR is different from the T-Bill Rate by more than 2.50%, plus 1.00% p.a.<br><br>**U.S. dollar facilities** - London interbank rate for U.S. dollar deposits, or LIBOR, for three-month U.S. dollar deposits plus 1.00% p.a.<br><br>**Yen facility** - LIBOR interbank rate for Yen deposits for three-month deposits plus 1.00% p.a. | | 181-day T-Bill Rate or the average of the 181-day T-Bill Rate and the 6-months PHIBOR, if 6-months PHIBOR is different from the T-Bill Rate by more than 2.50%, plus 1.00% p.a. | LIBOR for three-month deposits plus 1.00% p.a. |
| Interest payment dates | Quarterly in arrears | | Semi-annually | |

Under the terms of the restructuring, PLDT issued a LOS for the benefit of Piltel and its creditors under which PLDT has agreed to cover any funding shortfalls of Piltel up to a maximum amount of US$150 million less all amounts paid or committed to be paid to or on behalf of Piltel or any of its subsidiaries or affiliates on or after March 23, 2000. Under the LOS, PLDT shall provide funding to Piltel in the event that the cash flow from Piltel's operations fall short of the amount required by it to discharge in full its obligations to any creditor of Piltel and all its operating and financing subsidiaries and affiliates. PLDT is subject to contractual restrictions limiting the amount of financial support it can provide to Piltel up to US$150 million. As at December 31, 2004 and 2003, the undrawn balance available under the PLDT LOS is US$50 million, approximately Php2,831 million and Php2,793 million, respectively, due to prior investments made from March 23, 2000 to December 31, 2004 aggregating to US$100 million through PLDT's subscription to Class I Series J preferred shares of Piltel.

Piltel's restructured obligations are secured by substantially all present and future assets of Piltel under the Mortgage Trust Indenture, or MTI, dated June 4, 2001 between Piltel and Chase Manhattan Bank as security agent for the creditors, which established the security arrangements relating to the restructured debts. The participating creditors (other than the participating holders of the Peso Term Note Facility) will share equally in first ranking security, while non-participating creditors and the participating holders of the Peso Term Note Facility will share equally in second ranking security created under the MTI. Such mortgage was approved by at least two-thirds of Piltel's stockholders at its annual meeting on April 18, 2001 and the NTC on May 18, 2001.

*Satellite Acquisition Loans*

Mabuhay Satellite has an existing Credit Agreement with the Export-Import Bank of the United States, or Ex-Im Bank, to finance a portion of the cost of purchasing the Agila II Satellite. In 2003, Ex-Im Bank of the United States approved, in principle, the re-profiling of Mabuhay Satellite's US$42 million debt with them by extending the maturity of the loan by 1 and 1/2 years to July 15, 2007 and reducing the interest rate by 1%, to 5.6% from 6.6%. The revised repayment terms have been approved by the majority of the local creditor banks.

Mabuhay Satellite also has an existing Omnibus Agreement with a syndicate of local banks, or the Banks, which includes issuance of irrevocable standby Letters of Credit with an aggregate stated value not exceeding US$31 million (Php1,763 million) in favor of U.S. Ex-Im Bank of the United States, as security under the Credit Agreement and a term loan to Mabuhay Satellite in the aggregate amount of US$41 million (Php2,301 million), which will mature on various dates from 2005 to 2007.

Mabuhay Satellite has constituted in favor of the Banks: (a) a first mortgage on its leasehold rights under a lease agreement entered into with the Subic Bay Metropolitan Authority and the components of the satellite system; (b) an assignment of its rights under its purchase contract for the satellite system; (c) an assignment of its rights under the transponder lease contracts to be entered into with its shareholders and other parties and the revenues therefrom; and (d) an assignment of the applicable proceeds of insurance to be taken on the satellite system.

*Japanese Yen Debt*

*JBIC JP¥9,760 Million Overseas Investment Term Loan*

On July 26, 2002, PLDT signed a loan agreement with JBIC for a credit facility of JP¥9,760 million under JBIC's OIL program. The loan, which was drawn on July 31, 2002, will be amortized semi-annually beginning March 21, 2005 and will mature on March 21, 2008.

*NEXI Supported JP¥5,615 Million Syndicated Term Loan Facility*

On June 11, 2003, PLDT signed a JP¥5,615 million syndicated term loan facility supported by NEXI, of which JP¥2,520 million was drawn and JP¥2,205 million was outstanding as at December 31, 2004. The undrawn balance of JP¥3,095 million was cancelled at the end of the Availability Period on December 3, 2004. This loan is amortized semi-annually beginning December 2004 and will mature in June 2008.

*Philippine Peso Debt*

*Php2,770 Million Peso Fixed Rate Corporate Notes*

In connection with PLDT's service improvement and expansion programs, PLDT has entered into two loan agreements, pursuant to each of which PLDT issued fixed rate corporate notes in three tranches. Interest on each tranche is payable semi-annually.

Under the first loan agreement, PLDT borrowed an aggregate amount of Php1,500 million, of which Php230 million matured on November 11, 2002, Php500 million matured on November 9, 2004 and Php770 million will mature on November 9, 2006.

Under the second loan agreement, PLDT borrowed an aggregate amount of Php1,270 million, of which Php360 million matured on June 9, 2003, Php100 million will mature on June 9, 2005 and Php810 million on June 9, 2010.

*Term Loans*

*JBIC 4 Program of the Development Bank of the Philippines*

In connection with the Asia Pacific Cable Network 2 project, PLDT entered into a loan agreement with Citibank, N.A., as facility agent, and a syndicate of banks in the aggregate principal amount of Php1,700 million, of which about Php680 million was outstanding as at December 31, 2004. The loan, which is funded under the JBIC Facility for Private Sector Development of the Development Bank of the Philippines, will mature on October 26, 2005 and since April 2002 is payable in quarterly installments as set forth below:

| Quarterly Payment Number | Percentage of Principal Payable on Each Quarterly Payment Date |
|---|---|
| Payments 1-7 | 3.500% |
| Payments 8-11 | 8.875% |
| Payments 12-15 | 10.000% |

*Secured Term Loans*

*Php150 Million Term Loan Facility*

On March 4, 2002, ePLDT entered into a three-year loan facility with Philippine Bank of Communications amounting to Php150 million. The loan is payable in seven quarterly installments, with a grace period of one year, beginning year 2003. The loan facility was fully drawn on December 31, 2002. The quarterly principal payments of Php15 million started in June 2003 with a balloon payment of Php45 million in March 2005. Interest on this loan is equivalent to 91-day T-bill rate plus 4% per annum payable quarterly in arrears. The loan is secured by ePLDT's deed of assignment of receivables of a subsidiary from a foreign customer and an investment in an associate with an original cost of Php629 million. As at December 31, 2004, the investment in this associate has been fully provided for as disclosed in *Note 9 - Investments in Associates - at equity*. As at December 31, 2004, the outstanding balance of this loan amounted to Php45 million which will mature in 2005.

*Php100 Million Term Loan Facility*

On March 15, 2004, ePLDT entered into another three-year term loan facility with Asia United Bank amounting to Php100 million for the payment of its outstanding short-term bank loan facility and for other working capital requirements. The loan facility was fully drawn as at December 31, 2004. The loan is to be repaid in nine equal quarterly installments starting March 2005 with final repayment in March 2007. Interest on the loan is equivalent to 90-day PHIBOR plus 3% per annum payable quarterly in arrears. The loan is secured by a Mortgage Trust Indenture Agreement, or MTIA, on a parcel of land with a carrying value of Php279 million as at December 31, 2004. As at December 31, 2004, the outstanding balance of this loan amounted to Php100 million, of which Php44 million will mature in 2005.

*Php149 Million Term Loan Facility*

As at December 31, 2004, Vocativ, Inc., a wholly-owned call center subsidiary of ePLDT, has an outstanding 5-year term loan facility of Php149 million with Asia United Bank for the payment of its additional capital expenditures and working capital requirements. The loan is to be repaid in fourteen equal quarterly installments starting April 2006 with final repayment in July 2009. Interest on the loan is equivalent to 90-day PHIBOR plus 3% per annum payable quarterly in arrears. The loan is secured by a Mortgage Participation Certificate against the MTIA between ePLDT and Asia United Bank Corporation - Trust and Investments Group dated March 15, 2004 on a parcel of land, which excludes the buildings and improvements.

*Unsecured Term Loans*

*Php1,000 Million Term Loan Facility*

On June 14, 2001, Smart signed its GSM Phase 5A financing of Php1,000 million term loan. The outstanding balance under this facility of Php467 million was prepaid on June 28, 2004.

*Debt Covenants*

Our debt instruments contain restrictive covenants, including covenants that could prohibit us from paying dividends on common stock under certain circumstances, and require us to comply with specified financial ratios and other financial tests, calculated in conformity with accounting principles generally accepted in the Philippines, at relevant measurement dates, principally at the end of each quarterly period. We have complied with all of our maintenance ratios as required under our loan covenants and other debt instruments. In addition, we are required to comply with certain ratios for the incurrence of capital expenditures in excess of US$10 million and incurrence of indebtedness.

The principal factors that can negatively affect our ability to comply with financial ratios and other financial tests are depreciation of the peso relative to the U.S. dollar, poor operating performance of PLDT and its consolidated subsidiaries, impairment or similar charges in respect of investments or other long-lived assets that may be recognized by PLDT and its consolidated subsidiaries and increases in our interest expenses. Interest expense may increase as a result of various factors including issuance of new debt, the refinancing of lower cost indebtedness by higher cost indebtedness, depreciation of the peso, the lowering of PLDT's credit ratings or the credit ratings of the Philippines, increase in reference interest rates, and general market conditions. Since approximately 98% of PLDT's total debt is denominated in foreign currencies, principally in U.S. dollars, many of these financial ratios and other tests are negatively affected by any weakening of the peso.

PLDT's debt instruments contain a number of other negative covenants that, subject to certain exceptions and qualifications, restrict PLDT's ability to take certain actions without lenders' approval, including: (a) incurring additional indebtedness; (b) prepaying other debt; (c) making investments; (d) extending loans; (e) extending guarantees or assuming the obligations of other persons; (f) paying dividends or other distributions or redeeming, repurchasing or otherwise acquiring shares of PLDT's capital stock; (g) disposing of all or substantially all of its assets or of assets in excess of specified thresholds of its tangible net worth; (h) entering into management contracts providing for the management of its business or operations by a third party; (i) creating any lien or security interest; (j) permitting set-off against amounts owed to PLDT; (k) merging or consolidating with any other company; (l) entering into transactions with stockholders and affiliates; and (m) entering into sale and leaseback transactions.

Further, certain of PLDT debt instruments contain provisions wherein PLDT may be required to repurchase or prepay certain indebtedness in case of change in control of PLDT.

PLDT's debt instruments also contain customary and other default provisions that permit the lender to accelerate amounts due or terminate their commitments to extend additional funds under the debt instruments. These default provisions include: (a) cross-defaults and cross-accelerations that permit a lender to declare a default if PLDT is in default under another debt instrument; in some cases, the cross-default provision is triggered upon a payment or other default permitting the acceleration of PLDT's debt, whether or not the defaulted debt is accelerated. In other cases, the cross-default provision requires the defaulted loan to be accelerated. In some debt instruments, the cross-default provision will be triggered only if the principal amount of the defaulted indebtedness exceeds a threshold amount specified in these debt instruments; (b) failure by PLDT to meet certain financial ratio covenants referred to above; (c) the occurrence of any material adverse change in circumstances that a lender reasonably believes materially impairs PLDT's ability to perform its obligations under its debt instrument with the lender; (d) the revocation, termination or amendment of any of the permits or franchises of PLDT in any manner unacceptable to the lender; (e) the abandonment, termination or amendment of the project financed by a loan in a manner unacceptable to the lender; (f) the nationalization or sustained discontinuance of all or a substantial portion of PLDT's business; and (g) other typical events of default, including the commencement of bankruptcy, insolvency, liquidation or winding up proceedings by PLDT.

Smart's debt instruments contain certain restrictive covenants, including covenants that prohibit Smart from paying dividends, redeeming preferred stock, making distributions to PLDT or otherwise providing funds to PLDT or any affiliate without the consent of its lenders. Also, Smart's debt instruments contain certain restrictive covenants that require Smart to comply with specified financial ratios and other financial tests at semi-annual measurement dates. Smart has maintained compliance with all of its financial covenants. The agreements also contain customary and other default provisions that permit the lender to accelerate amounts due under the loans or terminate their commitments to extend additional funds under the loans. These default provisions include: (a) cross-defaults and cross-accelerations that permit a lender to declare a default if Smart is in default under another loan agreement. These cross-default provisions are triggered upon a payment or other default permitting the acceleration of Smart debt, whether or not the defaulted debt is accelerated; (b) failure by Smart to comply with certain financial ratio covenants; (c) any reduction in PLDT's ownership of Smart's shares below 51%; (d) any reduction in First Pacific's and Metro Pacific Corporation's collective direct and/or indirect ownership of PLDT's common stock below 17.5% of the total common stock outstanding; and (e) the occurrence of any material adverse change in circumstances that the lender reasonably believes materially impairs Smart's ability to perform its obligations under its loan agreements.

As at December 31, 2004, Piltel was not in compliance with the terms of convertible bonds with principal amount of US$0.7 million (approximately US$0.9 million redemption price at the option of the holders). Piltel may not be able to restructure or otherwise pay the claims of its unrestructured debt. However, default on and acceleration of Piltel's unrestructured indebtedness does not create a cross-default under Piltel's restructured indebtedness or any indebtedness of PLDT or Smart.

The Credit and Omnibus Agreements of Mabuhay Satellite impose negative covenants which, among others, restrict material changes in Mabuhay Satellite's nature of business and ownership structure, any lien upon or with respect to any of its assets or to any right to receive income, acquisition of capital stock, declaration and payment of dividends, merger, consolidation and sale with another entity and incurring or guaranteeing additional long-term debt beyond prescribed amounts.

ePLDT's loan agreement imposes negative covenants which, among other things, restrict ePLDT in regard to payment of cash dividends or any other income or any capital distribution to PLDT, voluntary suspension of its entire business operations for a period of 60 consecutive days, dissolution of its legal existence, and creation of any encumbrances on the shares pledged. One of ePLDT's loan agreement also requires ePLDT to comply with specified financial ratios and other financial tests at quarterly measurement dates. The agreement also contains customary and other default provisions that permit the lender to accelerate amounts due under the loan or terminate their commitments to extend additional funds under the loan. As at December 31, 2004, ePLDT has complied with all of its financial covenants.

### *Obligations Under Capital Lease*

The future minimum payments for capitalized leases are as follows as at December 31, 2004:

| Year | (in million pesos) |
|---|---|
| 2005 | 673 |
| 2006 | 379 |
| 2007 | 258 |
| 2008 | 6 |
| 2009 | 7 |
| 2010 and onwards | 443 |
| Total minimum lease payments | 1,766 |
| Less amount representing interest | 740 |
| Present value of net minimum lease payments | 1,026 |
| Less capital lease maturing within one year | 425 |
| Long-term portion of obligations under capital lease | 601 |

*Municipal Telephone Projects*

In 1993, PLDT entered into two lease agreements with the Philippine Department of Transportation and Communications, or DOTC, covering telecommunications facilities in Bohol and Batangas established under the Municipal Telephone Act. Under these agreements, PLDT was granted the exclusive right to perform telecommunications management services, to expand services, and to promote the use of the DOTC-contracted facilities in certain covered areas for a period of 15 years. Title to the properties shall be transferred to PLDT upon expiration of the lease term. As at December 31, 2004, PLDT's aggregate remaining obligation under this agreement was approximately Php858 million. In case of cancellation, PLDT is liable to pay Php100 million under each of the two contracts as liquidated damages.

On June 1, 2004, PLDT served the DOTC a notice of termination of the lease agreement in respect of the telecommunications system in Bohol which state of deterioration, obsolescence and disrepair have made it impossible for PLDT to continue managing, operating, and maintaining the system. Since 2002, PLDT has been advising the DOTC of the need to review the viability of the system as it has infused more than Php200 million for upgrades and maintenance to keep the system operable. Further, the enactment of R.A. No. 7925, which negated the DOTC's warranty to grant PLDT the exclusive right to provide telecommunication services in the areas stipulated, prevented PLDT from achieving the originally projected profitability thereby rendering it impossible for PLDT to continue fulfilling its obligation under the lease agreement. Although several discussions have been held since then to seek a mutually acceptable agreement, no amenable arrangement has been reached. On June 30, 2004, the DOTC advised PLDT that the request for termination of the lease agreement in Bohol has been referred to the Department of Justice, or DOJ, as government agencies are required to refer all interpretation of contracts and agreements to the DOJ secretary as attorney-general of the national government. As of the date of this report, negotiations are on-going in efforts to reach a mutually beneficial arrangement for both parties. As at December 31, 2004, the net book value of the telecommunications system in Bohol, including PLDT's additional capital expenditure relating to the telecommunications system, and corresponding capital lease obligation amounted to Php42 million and Php735 million, respectively.

*Other Long-term Capital Lease Obligations*

The PLDT Group has various long-term lease contracts for a period of three years covering various office equipment. In particular, Smart and Piltel have capital lease obligations aggregating Php906 million as at December 31, 2004 in respect of office equipment and facilities.

Under the terms of certain loan agreements and other debt instruments, PLDT may not create, incur, assume or permit or suffer to exist any mortgage, pledge, lien or other encumbrance or security interest over the whole or any part of its assets or revenues or suffer to exist any obligation as lessee for the rental or hire of real or personal property in connection with any sale and leaseback transaction.

### *Preferred Stock Subject to Mandatory Redemption*

The movement of PLDT's preferred stock subject to mandatory redemption follows:

| | 2004 | | | | 2003 | | | |
|---|---|---|---|---|---|---|---|---|
| | **Series V** | **Series VI** | **Series VII** | **Total** | Series V | Series VI | Series VII | Total |
| | | | | (in million pesos) | | | | |
| Balance at beginning of year | **2,053** | **5,435** | **5,247** | **12,735** | 1,717 | 4,347 | 4,177 | 10,241 |
| Issuance | **-** | **-** | **-** | **-** | - | 282 | - | 282 |
| Conversion | **(339)** | **(18)** | **-** | **(357)** | - | (8) | - | (8) |
| Accretion | **390** | **751** | **457** | **1,598** | 336 | 607 | 375 | 1,318 |
| Revaluation | **-** | **74** | **325** | **399** | - | 207 | 695 | 902 |
| Balance at end of year | **2,104** | **6,242** | **6,029** | **14,375** | 2,053 | 5,435 | 5,247 | 12,735 |

As at December 31, 2004, PLDT had issued 3 million shares of Series V Convertible Preferred Stock, 5 million shares of Series VI Convertible Preferred Stock and 4 million shares of Series VII Convertible Preferred Stock in exchange for Series K Class I Convertible Preferred Stock of Piltel, pursuant to the debt restructuring plan of Piltel. Shares of Series V, VI and VII Convertible Preferred Stock are entitled to receive annual dividends of Php18.70 per share, US$0.397 per share and JP¥40.7189 per share, respectively. Each share of Series V, VI and VII PLDT 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 Stock 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 will be able to require PLDT to purchase such PLDT common shares for Php1,700 per share, US$36.132 per share, and JP¥4,071.89 per share for Series V, VI and VII, respectively.

PLDT's Convertible Preferred Stock Series V, VI and VII were designated as compound instruments consisting of liability and equity components. The total fair value of the Convertible Preferred Stock Series V, VI and VII was determined at issue date, of which the aggregate fair value of the liability component of the issued Series V, VI and VII Convertible Preferred Stock as at date of issuance is included under the "Interest-bearing Financial Liabilities" account in the consolidated balance sheets. The residual amount was assigned as the equity component.

The difference between the aggregate fair value of the Series V, VI and VII Convertible Preferred Stock at issue date and the aggregate redemption value is accreted over the period up to the call option date using the effective interest rate method. Accretions added to "Preferred Stock Subject to Mandatory Redemption" and charged to interest for the years ended December 31, 2004 and 2003 amounted to Php1,598 million and Php1,318 million, respectively.

"Preferred Stock Subject to Mandatory Redemption" amounted to Php14,375 million and Php12,735 million as at December 31, 2004 and 2003, respectively, after revaluation of Series VI and VII to the exchange rates at balance sheet dates and after giving effect to the above accretions, conversions and additional issuances. As at December 31, 2004 and 2003, 1,060,940 shares and 676,571 shares, respectively, of the Convertible Preferred Stock have been converted into PLDT common shares. The aggregate redemption value of the outstanding Series V, VI and VII Convertible Preferred Stock amounted to Php22,016 million and Php21,898 million as at December 31, 2004 and 2003, respectively.

The corresponding dividends on these shares charged as interest expense amounted to Php284 million, Php254 million and Php240 million for the years ended December 31, 2004, 2003 and 2002, respectively.

### *Notes Payable*

On April 28, 2003 and May 14, 2003, PLDT issued, at a discount, Php1,600 million and Php400 million One-Year Peso Notes, respectively, under its Php2 billion Peso Notes program registered with the Philippine Securities and Exchange Commission. Net proceeds of the issue totaled Php1,803 million. The Php1,600 million One-Year Peso Note matured on April 22, 2004 and the Php400 million One-Year Peso Note matured on May 11, 2004.

Parlance Systems, Inc., a wholly-owned call center subsidiary of ePLDT, Inc., has availed of a local bank's Export Packing and Credit Loan facility amounting to US$950,000 as at December 31, 2004. The said facility can be availed by an export Letter of Credit with an 80% loan value. It has a 90-day term from the date it was granted by the bank and is supported by a Deed of Assignment of Receivables. Interest is based on the prevailing bank rate to be collected in arrears on a monthly basis.

## 19. Other Noncurrent Liabilities

This account consists of:

| | **2004** | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | (in million pesos) | |
| Capital expenditures under long-term financing | **3,970** | 3,130 |
| Prepayment received under receivable purchase facility (Note 15) | **1,644** | 2,058 |
| Asset retirement obligations (Note 8) | **638** | 395 |
| Unearned revenues | **85** | 35 |
| Others | **822** | 193 |
| | **7,159** | 5,811 |

## 20. Accrued Expenses and Other Current Liabilities

This account consists of:

| | **2004** | 2003 |
|---|---|---|
| | | (As restated - Note 2) |
| | (in million pesos) | |
| Accrued utilities and related expenses | **4,457** | 4,101 |
| Accrued taxes and related expenses | **2,886** | 2,406 |
| Accrued interest on various loans (Notes 18 and 21) | **2,235** | 2,377 |
| Accrual for payment for unused sick leave and other employee benefits | **1,624** | 1,521 |
| Payable in installment purchase of equity investment (Note 10) | **1,561** | - |
| Others | **2,048** | 1,414 |
| | **14,811** | 11,819 |

## 21. Related Party Transactions

*a. Air Time Purchase Agreement between PLDT and AIL and Related Agreements*

In March 1997, PLDT entered into a National Service Provider, or Founder NSP, Air Time Purchase Agreement with PT Asia Cellular Satellite (assigned and transferred to AIL), as amended in December 1998, under which PLDT was granted the exclusive right to sell ACeS services in the Philippines. In exchange, the Air Time Purchase Agreement states that PLDT has to purchase from PT Asia Cellular Satellite at least US$5 million worth of air time annually over ten years, commencing on the commercial operations date, which has been set as January 1, 2002. The commercial operations date is defined as the earlier of:

- the day on which PT Asia Cellular Satellite places the Garuda I satellite in commercial operation; and
- the date of final acceptance of the Garuda I satellite and associated equipment under the terms of the Spacecraft Contract, dated August 28, 1995, between PT Asia Cellular Satellite and Martin Marietta Overseas Corporation.

However, the commercial operations date may not occur without the consent of PLDT if there is a constructive total loss or partial loss of the satellite under its launch insurance contract and the satellite cannot provide commercial service in the Philippines.

In the event that PT Asia Cellular Satellite's aggregate billing revenue is less than US$45 million in any given year, the Air Time Purchase Agreement 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. In lieu of these payments, 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 for the year 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 will cover, among other matters, the amended minimum and supplemental air time payment provisions subject to the approval of AIL's creditors.

On February 10, 2004, notwithstanding the on-going negotiations, AIL advised PLDT of the termination of the Standstill Agreement and the reinstatement of the terms under the original Air Time Purchase Agreement following the lapse of the deadline set in the Standstill Agreement for the establishment of a revised Air Time Purchase Agreement. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter. See *Note 24 - Provisions and Contingencies* for further discussion.

PLDT also entered into a Founder NSP Operating Agreement with PT Asia Cellular Satellite on March 12, 1997, under which PLDT may:

- authorize distributors to resell ACeS services in the Philippines upon prior approval from PT Asia Cellular Satellite; and
- appoint agents to solicit and bill PLDT's or its authorized distributors' subscribers for ACeS services and to sell terminals on behalf of PLDT.

Under an Assignment and Assumption Agreement dated December 29, 1998, PT Asia Cellular Satellite agreed to assign and transfer to AIL of PT Asia Cellular Satellite's rights under the Founder NSP Air Time Purchase Agreement and Founder NSP Operating Agreement.

Under an Acknowledgment of Assignment of Air Time Purchase Agreement entered into on December 29, 1998, by and among PLDT, P.T. Bank Internasional Indonesia and AIL, PLDT consented to the assignment by AIL of the Founder NSP Air Time Purchase Agreement to P.T. Bank Internasional Indonesia, as security agent, for the benefit of the secured parties under the Security Agreement dated as at December 29, 1998, which was executed in connection with the Amended and Restated Credit Agreement dated December 29, 1998 among PT Asia Cellular Satellite, AIL, P.T. Bank Internasional Indonesia and various banks.

On September 30, 2002, PT Asia Cellular Satellite, AIL, as guarantor, P.T. Bank Internasional Indonesia, as security agent, and various other banks signed a Rescheduling Agreement, which amended the terms of the Amended and Restated Credit Agreement dated December 29, 1998, moving the principal repayment dates to agreed periods with the final maturity date on January 30, 2012.

*b. Transactions with Major Stockholders, Directors and Officers*

Transactions to which PLDT or its subsidiary was a party, in which a director or key officer or owner of more than 10% of the 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 common shares of PLDT had a direct or indirect material interest in PLDT or its subsidiary, as at December 31, 2004 and 2003 and for the three years ended December 31, 2004, 2003 and 2002 are as follows:

*1. Agreements with NTT Communications and/or its Affiliates*

PLDT is a party to the following agreements with NTT Communications and/or its affiliates:

- *Advisory Services Agreement.* On March 24, 2000, PLDT entered into an agreement with NTT Communications, as amended on December 31, 2003, under which NTT Communications provides PLDT with technical, marketing and other consultants for various business areas of PLDT starting April 1, 2000;

- *Domestic Fiber Optic Network Submerged Plant Maintenance Agreement.* On July 4, 2000, PLDT entered into an agreement with NTT World Engineering Marine Corporation, or NTT WEMC, for the submarine cable repair and other allied services for the maintenance of PLDT's domestic fiber-optic network, or DFON, submerged plant for a period of five years up to July 4, 2005. Under the agreement, PLDT shall pay NTT WEMC a fixed annual standing charge of US$2 million, excluding cost for the use of a remotely operated submersible vehicle at US$5,000 for every day of use and repair cost computed at US$19,000 per day of actual repair;

- *Arcstar Licensing Agreement and Arcstar Service Provider Agreement.* On March 24, 2000, PLDT entered into an agreement with NTT Worldwide Telecommunications Corporation under which PLDT markets managed data and other services under NTT Communications' "Arcstar" brand to its corporate customers in the Philippines. PLDT also entered into a Trade Name and Trademark Agreement with NTT Communications under which PLDT has been given the right to use the tradename "Arcstar" and its related trademark, logo and symbols, solely for the purpose of PLDT's marketing, promotional and sales activities for the Arcstar services within the Philippines; and

- *Conventional International Telecommunications Services Agreement.* On March 24, 2000, PLDT entered into an agreement with NTT Communications under which PLDT and NTT Communications agreed to cooperative arrangements for conventional international telecommunications services to enhance their respective international businesses.

Total fees under these agreements amounted to Php336 million, Php288 million and Php289 million for the years ended December 31, 2004, 2003 and 2002, respectively. As at December 31, 2004 and 2003, outstanding obligations of PLDT amounted to Php49 million and Php40 million, respectively.

*2. Agreement between Smart and Asia Link B.V., or ALBV.* Smart has an existing Technical Assistance Agreement with ALBV for the latter to provide technical support services and assistance in the operations and maintenance of cellular business for a period of five years, subject to renewal upon mutual agreement between the parties. The agreement provides for quarterly payments of technical service fees equivalent to 2% of the net revenues of Smart. In January 2003, the agreement was amended, reducing the technical service fees to be paid by Smart to ALBV to 1% of net revenues effective January 1, 2003.

Smart also has an existing Services Agreement with ALBV for a period of 25 years starting January 1, 1999, which shall automatically expire unless renewed by mutual agreement of both parties. Under the agreement, ALBV provides advice and assistance to Smart in sourcing capital equipment and negotiating with international suppliers, arranging international financing and other services therein consistent with and for the furtherance of the objectives of the services. Service agreement fees were paid for the whole 25-year period.

ALBV is a subsidiary of the First Pacific Group.

Total fees under these agreements amounted to Php507 million for the year ended December 31, 2004 and Php429 million for each of the years ended December 31, 2003 and 2002. Outstanding obligations of Smart under the Technical Service Agreement amounted to Php267 million and Php228 million as at December 31, 2004 and 2003, respectively.

*3. Agreements relating to insurance companies.* Gotuaco del Rosario and Associates, or Gotuaco, acts as the broker for certain insurance companies to cover certain 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 payments to Gotuaco and Malayan covering the 12-month period ending July 31, 2005 amounted to Php440 million. Two directors of PLDT have a direct/indirect interest in or serve as director/officer of Gotuaco and Malayan.

### *Compensation of Key Management Personnel of the PLDT Group*

The aggregate compensation and benefits paid to the directors, the chief executive officer and other key advisors and officers, as a group, for 2004, 2003 and 2002 amounted to approximately Php217 million, Php218 million and Php196 million, respectively.

Each of the directors, including the members of the advisory board of PLDT, is entitled to a director's fee in the amount of Php125,000 for each meeting of the board attended, except Manuel V. Pangilinan, our Chairman, who has waived his right to receive a director's fee. Each of the members or advisors of the audit, executive compensation, nomination and finance committees is entitled to a fee in the amount of Php50,000 for each committee meeting attended.

There are no agreements between PLDT and any of its directors and key officers providing for benefits upon termination of employment, except for such benefits to which they may be entitled under PLDT's retirement plan.

## 22. Employee Benefits

### *Executive Stock Option Plan, or ESOP*

On April 27, 1999 and December 10, 1999, the Board of Directors and stockholders, respectively, approved the establishment of an ESOP and the amendment of the Seventh Article of the Articles of Incorporation of PLDT denying the pre-emptive right of holders of common stock to subscribe for any issue of up to 1,289,745 common stock pursuant to the ESOP. The ESOP covers management executives, which include officers with rank of Vice President up to the President, executives with the rank of Manager up to Assistant Vice President, and advisors/consultants engaged by PLDT. The ESOP seeks to motivate option holders to achieve PLDT's goals, reward option holders for the creation of shareholder value, align the option holders' interests with those of the stockholders of PLDT and retain the option holders to serve the long-term interests of PLDT. The ESOP is administered by the Executive Compensation Committee of the Board of Directors. About 1.3 million common stock of PLDT have been reserved as underlying shares of options under the ESOP in 1999.

Movements in the number of stock option plan outstanding are as follows:

| | **2004** | 2003 |
|---|---|---|
| Balance at beginning of year | **900,118** | 1,226,395 |
| Exercised shares* | **(336,745)** | - |
| Cancelled | **(26,784)** | (326,277) |
| Balance at end of year | **536,589** | 900,118 |

* Based on date of payment of exercised shares.

Since the date of the grant on December 10, 1999 up to December 31, 2003, there were no officers or executives who exercised their options. Instead, there were cancellations of options due to officer resignations and retirements of officers and executives.

For the year ended December 31, 2004, 336,745 shares were exercised by certain officers and executives at an exercise price of Php814 per share. Of the 336,745 exercised shares, 1,649 shares were unissued as at December 31, 2004.

The fair value of the ESOP plan was estimated at the date of grant using an option pricing model, which considered annual volatility of 40%, risk-free interest rate, expected life of option, exercise share price of Php814 and weighted average share price Php870 for the 1999 Grant and Php315 for the 2002 Grant as at valuation date. Total fair value of shares granted as at December 31, 2004 and 2003 amounted to Php359 million and Php364 million, respectively. The fair value of the options recognized as an expense for the years ended December 31, 2004 and 2002 amounted to Php14 million and Php76 million, respectively and recovery of Php10 million for the year ended December 31, 2003 due to cancellation of option before vesting period.

### *LTIP*

On August 3, 2004, PLDT's Board of Directors approved the establishment of an LTIP for eligible key executives and advisors of PLDT and its subsidiaries. The LTIP is a four-year cash plan covering the period January 1, 2004 to December 31, 2007. The awards payment at the end of the four-year period (without interim payments) is contingent upon the achievement of the approved target increase in PLDT's common share price by the end of the plan period and the cumulative consolidated net income target for the plan period. The target increase in the PLDT base share price, which is the average of the closing prices of PLDT shares ten trading days before or after December 31, 2003, is approximately 15% per annum compounded for the plan period.

The fair value of the LTIP was estimated using an option pricing model, which considered annual stock volatility, risk-free interest rate, expected life of option of four years and weighted average share price Php1,360 as at valuation date. The fair value of the options recognized as an expense for the year ended December 31, 2004 amounted to Php661 million.

### *Pension*

*Defined Benefit Plans*

We have defined benefit pension plans, covering substantially all of our employees, except Smart, of which require contributions to be made to separate administrative fund.

The following tables summarize the components of net benefit expense recognized in the consolidated statements of income and the funded status and amounts recognized in the consolidated balance sheets for the plan.

| | **2004** | 2003 | 2002 |
|---|---|---|---|
| | | (in million pesos) | |
| Change in benefit obligation: | | | |
| Benefit obligation at beginning of year | **6,008** | 8,012 | 6,654 |
| Service cost | **401** | 532 | 461 |
| Interest cost | **539** | 718 | 795 |
| Benefits paid | **(819)** | - | (495) |
| Actuarial loss (gain) | **787** | (1,236) | 597 |
| Curtailment | **-** | 274 | - |
| Settlement | **-** | (2,275) | - |
| Liabilities of newly acquired subsidiaries | **8** | - | - |
| Benefits paid from assets | **-** | (17) | - |
| Benefit obligation at end of year | **6,924** | 6,008 | 8,012 |
| Change in plan assets: | | | |
| Fair value of plan assets at beginning of year | **3,928** | 2,915 | 2,781 |
| Actual return on plan assets | **376** | 303 | 369 |
| Employer's contribution | **883** | 2,704 | 470 |
| Benefits paid | **(819)** | - | (495) |
| Settlement | **-** | (2,275) | - |
| Benefits paid from assets | **-** | (17) | - |
| Actual gains (losses) on plan assets | **81** | 298 | (210) |
| Fair value of plan assets at end of year | **4,449** | 3,928 | 2,915 |
| Funded status | **2,475** | 2,080 | 5,097 |
| Unrealized net transition obligation | **(120)** | (177) | (264) |
| Unrecognized net actuarial loss (gain) | **(176)** | 528 | (807) |
| Accrued benefit cost | **2,179** | 2,431 | 4,026 |
| Components of net periodic benefit cost: | | | |
| Service cost | **401** | 532 | 461 |
| Interest cost | **539** | 718 | 795 |
| Actual return on plan assets | **(376)** | (303) | (369) |
| Amortizations of unrecognized net transition obligation | **56** | 64 | 64 |
| Recognition of transitional liability | **4** | 3 | 2 |
| Net periodic benefit cost | **624** | 1,014 | 953 |

The weighted average assumptions used to determine pension benefits as at December 31, 2004 and 2003 are as follows:

| | **2004** | 2003 |
|---|---|---|
| Discount rate | **9%** | 9% |
| Rate of increase in compensation | **7%** | 7% |
| Rate of return on plan assets | **9%** | 9% |

As at December 31, 2004, our plan assets include investments in shares of stock of PLDT and Piltel aggregating Php448 million, which represent about 5% of our total plan assets.

*Defined Contribution Plan*

Smart maintains a trustee-managed, tax-qualified, multi-employer plan covering substantially all permanent and regular employees. The plan has a defined contribution format wherein Smart's obligation is limited to specified contribution to the plan. It is being financed by the participating companies (Smart and its subsidiary, I-Contacts, Inc.) and employees' contribution is optional.

| | **2004** | 2003 | 2002 |
|---|---|---|---|
| | | (in million pesos) | |
| Expense recognized for defined benefit plans | **624** | 1,014 | 953 |
| Expense recognized for defined contribution plan | **36** | 41 | 45 |
| | **660** | 1,055 | 998 |

## 23. Contractual Obligations and Commercial Commitments

***Contractual Obligations***

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

| | | Payments Due by Period | | | |
|---|---|---|---|---|---|
| | **Total** | **Within 1 year** | **2-3 years** | **4-5 years** | **After 5 years** |
| | | | (in million pesos) | | |
| Long-term debt[1] | 159,470 | 28,031 | 55,257 | 20,782 | 55,400 |
| Long-term lease obligations: | | | | | |
| Operating lease | 5,712 | 1,435 | 2,439 | 723 | 1,115 |
| Capital lease | 1,766 | 673 | 637 | 13 | 443 |
| Unconditional purchase obligations[2] | 12,302 | 4,405 | 2,263 | 2,253 | 3,381 |
| Other long-term obligations | 22,016 | - | - | 22,016 | - |
| Total contractual cash obligations | **201,266** | **34,544** | **60,596** | **45,787** | **60,339** |

(1) Includes 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 18 - Interest-bearing Financial Liabilities.*

*Long-term Operating Lease Obligations*

*Domestic Fiber Optic Network Submerged Plant Agreement*. As discussed in *Note 21 - Related Party Transactions*, PLDT entered into an agreement with NTT World Engineering Marine Corporation, or NTT WEMC, on July 4, 2000, for the submarine cable repair and other allied services in relation to the maintenance of PLDT's DFON submerged plant for a period of five years up to July 4, 2005. Under this agreement, PLDT shall pay NTT WEMC, a fixed annual standing charge of US$2 million, excluding cost for the use of a remotely-operated submersible vehicle at US$5,000 for every day of use and repair cost computed at US$19,000 per day of actual repair. As at December 31, 2004, PLDT's aggregate remaining obligation under this agreement was approximately Php69 million.

*Digital Passage Service Contracts*. PLDT has existing Digital Passage Service Contracts with foreign telecommunication administrations for several dedicated circuits to various destinations for 10 to 25 years expiring at various dates. As at December 31, 2004, PLDT's aggregate remaining obligation under these contracts amounted to approximately Php30 million.

*License Agreement with Mobius Management Systems (Australia) Pty Ltd., or Mobius.* PLDT entered into a license agreement with Mobius pursuant to which Mobius has granted PLDT a non-exclusive, non-assignable and non-transferable license for the use of computer software components. Under this agreement, Mobius is also required to provide maintenance services for a period of one year at no additional maintenance charge. PLDT may purchase maintenance services upon expiration of the first year for a fee of 15% of the current published license fee. As at December 31, 2004, PLDT's aggregate remaining obligation under this agreement was approximately Php45 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 Php3,185 million as at December 31, 2004 in respect of office and cell site rentals with over 2,000 lessors nationwide.

*Long-term Capital Lease Obligations*

For a discussion of our long-term capital lease obligations, see *Note 18 - Interest-bearing Financial Liabilities*.

*Unconditional Purchase Obligations*

*Air Time Purchase Agreement with AIL.* As discussed in *Note 21 - Related Party Transactions*, PLDT is a party to a Founder NSP Air Time Purchase Agreement with AIL in March 1997, which was amended in December 1998, under which PLDT is granted the exclusive right to sell AIL services in the Philippines. In exchange, the Air Time Purchase Agreement states that PLDT has to purchase from AIL a minimum of US$5 million worth of air time annually over ten years commencing on the date of the commercial operations of the Garuda I satellite. In the event AIL's aggregate billing revenue is less than US$45 million in any given year, the Air Time Purchase Agreement also states that PLDT has to make supplemental air time purchase payments not to exceed US$15 million per year during the ten-year term.

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. In lieu of these payments, 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. PLDT is also obliged to purchase from AIL 13,750 satellite phone units for the year 2003 at US$395 F.O.B. per unit, subject to quarterly price adjustment. The parties to the Standstill Agreement also agreed to negotiate in good faith and use their best efforts to reach agreement on a revised Air Time Purchase Agreement before November 15, 2003 that will cover, among others, the amended minimum and supplemental air time payment provisions subject to the approval of AIL's creditors.

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

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

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

Effective July 1, 2004, VeriSign has agreed to amend the Agreement and issued Addendum 8 as extension of Addendum 6. Annual support fee for year 5 (September 2004 to August 2005) will remain at US$40,000 and affiliate revenue sharing rates will remain at 25%. As at December 31, 2004, ePLDT's aggregate remaining minimum obligation under this agreement was approximately Php18 million pertaining to annual support fee.

*License Purchase Agreement with I-Contact Solutions Pte. Ltd.* On April 2, 2003, iPlus Intelligent Network Inc., or iPlus, a wholly-owned subsidiary of ePLDT and the Philippines' pioneer in IP-based IT response center, entered into an Application Services Provider, or ASP, and Reseller Contract with I-Contact Solutions Pte. Ltd., or I-Contact, of Singapore. Under the agreement, iPlus will purchase licenses of the CosmoCall Universe ™ IP-based contact center solution. CosmoCall Universe supports multi-channel customer interactions including telephone, web chat, web voice, web video, web collaboration, e-mail and voicemail in one high capacity, high availability, multi-tenant platform. CosmoCall Universe is a complete, unified contact center suite that includes ACD, IVR, CTI, predictive dialing, multimedia recording and a complement of other management applications. The aggregate value of these licenses is US$2.1 million and these licenses will be delivered quarterly over a two-year period. Further to the agreement, I-Contact will appoint iPlus as the exclusive reseller and ASP for the Philippine market and will provide iPlus with all the necessary support in terms of sales, marketing, and technical services. Effective March 30, 2004, I-Contact has agreed to amend the Contract and waived all financial obligations and committed seats requirement over the two-year period. iPlus will pay all its remaining obligations pertaining only to the 300 seats delivered by I-Contact. As at December 31, 2004, iPlus has paid all its obligations to I-Contact.

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

*Other Long-term Obligations*

*Mandatory Conversion and Purchase of Shares*. As discussed in *Note 9 - Investments in Associates - at equity* and *Note 18 - Interest-bearing Financial Liabilities*, as at December 31, 2004, PLDT had issued a total of 3 million shares of Series V Convertible Preferred Stock, 5 million shares of Series VI Convertible Preferred Stock and 4 million shares of Series VII Convertible Preferred Stock in exchange for Series K Class I Convertible Preferred Stock of Piltel, pursuant to the debt restructuring plan of Piltel.

Each share of Series V, VI, and VII Convertible Preferred Stocks is convertible at any time at the option of the holder into one PLDT's 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's common shares. Under a put option exercisable for 30 days, holders of common shares received on mandatory conversion will be able to require PLDT to purchase such PLDT common shares for Php1,700 per share, US$36.132 per share, and JP¥4,071.89 per share for Series V, VI and VII, respectively.

As at December 31, 2004, 515,818 shares of Series V Convertible Preferred Stock and 545,122 shares of Series VI Convertible Preferred Stock had been converted to PLDT's common shares. The aggregate value of the put option based on outstanding shares as at December 31, 2004 was Php22,016 million, of which Php13,419 million is payable on June 4, 2008 and Php8,597 million on June 4, 2009, if all of the outstanding shares of Series V, VI and VII Convertible Preferred Stocks were mandatorily converted and all the underlying common shares were put to PLDT. The market value of the underlying common shares was Php14,685 million, based on the market price of PLDT's common shares of Php1,360 per share as at December 31, 2004.

***Commercial Commitments***

As at December 31, 2004, our outstanding commercial commitments, in the form of letters of credit, amounted to Php1,504 million. These commitments will expire within one year.

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

In January 2004, Smart signed a new MPO in favor of Nokia amounting to US$117 million (Phase 7 under the Frame Supply Contract between Smart and Nokia). This MPO has been completed as at December 31, 2004.

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

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

As at December 31, 2004, Smart had no guarantee obligations, standby repurchase obligations or other commercial commitments.

## 24. Provisions and Contingencies

***NTC supervision and regulation fees, or SRF***

Since 1976, PLDT has received assessments from NTC for permit, SRF and other charges pursuant to Section 40 of Commonwealth Act 146, otherwise known as the Public Service Act. As at December 31, 2004, PLDT has paid, since 1994, a total amount of Php1,718 million in SRF, of which Php1,508 million was paid under protest.

PLDT is contesting the manner by which these assessments were calculated and the basis for such calculations. The case is now with the Supreme Court and upon the rules and practice of court, stands submitted for decision.

Smart and Piltel have similarly received assessments from NTC for permit, SRF and other charges which were paid under protest. Total payments amounted to Php122 million each in 2004 and 2003.

We have made a reasonable estimate of the amount necessary to pay or settle the contested assessment in the event of an unfavorable judgment against us and have made the appropriate provisions in our consolidated financial statements as at December 31, 2004.

***Local business and franchise tax assessments***

PLDT is presently a party to several cases involving the issue of exemption of PLDT from local franchise and business taxes. PLDT believes, based on the opinion of its legal counsel, that it is exempt from payment of local franchise and business taxes.

The Local Government Code of 1991, or R.A. No. 7160, which took effect on January 1, 1992, extended to local government units, or LGUs, power to tax businesses within their territorial jurisdiction granted under Batas Pambansa No. 337 and withdrew tax exemptions previously granted to franchise grantees under Section 12 of R.A. No. 7082.

PLDT believes, based on the opinion of its legal counsel, that Public Telecommunications Policy Act, or R.A. No. 7925, which took effect on March 16, 1995, and the grant of local franchise and business taxes exemption privileges to other franchise holders subsequent to the effectivity of R.A. No. 7160, implicitly restored its local franchise and business taxes exemption privilege under Section 12 of R.A. No. 7082, or the PLDT Franchise pursuant to Section 23 thereof or the quality of treatment clause.

To confirm this position, PLDT sought and obtained on June 2, 1998 a ruling from the Bureau of Local Government Finance, or BLGF, of the Philippine Department of Finance, which ruled that PLDT is exempt from the payment of local franchise and business taxes imposable by LGUs under R.A. No. 7160.

By virtue of the BLGF Ruling, PLDT stopped paying local franchise and business taxes starting with the fourth quarter of 1998 and has filed with certain LGUs claims for tax refund covering the period from the second quarter of 1995 to the third quarter of 1998. PLDT has received assessments for local franchise and business tax from several cities and provinces following PLDT's decision to stop payment of local franchise and business taxes.

Following a decision of the Supreme Court on March 25, 2003, a judgment in the amount of Php4 million against PLDT involving the City of Davao became final and executory on April 9, 2003, pursuant to which PLDT was declared not exempt from the local franchise tax. Although PLDT believes that it is not liable to pay local franchise and business taxes, PLDT has taken steps to arrive at compromise settlements with several LGUs in order to maintain and preserve its good standing and relationship with these LGUs. PLDT has paid a total amount of Php329 million as at December 31, 2004 for local franchise tax covering up to end of 2004 to certain LGUs who have agreed to a compromise settlement.

PLDT continues to contest remaining assessments amounting to Php3.7 million, a number of which were based on the gross revenues of PLDT derived from its operations within the entire Philippines. PLDT claims that assuming that it is liable for local franchise tax, R.A. No. 7160 provides that local franchise tax shall be based on the gross receipts of the preceding year received or collected for services rendered within the jurisdiction of the taxing authority. Therefore, the use by some LGUs of gross revenues as the basis for computation of franchise tax is in gross violation of the law because it pertains to all income earned regardless of whether it was received or not, unlike gross receipts which are essentially the amount of money or its equivalent actually or constructively received. Moreover, gross revenues refer to all income earned by PLDT within and outside the jurisdiction of the local taxing authority; thus, the use thereof as a basis of computation will exceptionally overstate the franchise tax.

In a petition recently filed with the Supreme Court involving another LGU, PLDT has appealed to the Supreme Court for a re-examination of its decision in the City of Davao case in light of the strong dissenting opinion in that case concurred in by four (4) other Justices of the Supreme Court.

Smart has, likewise, received assessments for local franchise and business taxes from certain cities and provinces in the aggregate amount of Php313 million, which Smart continues to contest. Smart believes, based on the opinion of its legal counsel, that Smart is not liable to pay the local franchise and business taxes by virtue of (i) the opinion issued by the BLGF dated August 13, 1998; and (ii) Smart's exemption under its legislative franchise which took effect after the effective date of R.A. No. 7160.

Smart has recently been declared exempt from payment of local franchise tax to the City of Makati in a decision dated August 3, 2004 by the Regional Trial Court of Makati. The City of Makati has filed their motion for reconsideration and Smart has filed its opposition.

Piltel also received assessments from the local government of the City of Makati in the aggregate amount of Php45 million covering the period from 1999 to 2001. Piltel has formally protested the assessments, based on: (1) Piltel's belief that the opinion rendered by the BLGF for Smart should likewise hold true for Piltel; and (2) the effective date of the legislative franchise of Piltel (R.A. 7293) which came after the effectivity of R.A. 7160. The franchise tax prescribed under Section 137 of the Local Government Code is deemed part of the Piltel franchise (the later law) which states, among other things, that Piltel shall pay only a franchise tax equivalent to 3% of all gross receipts of the business transacted under its franchise and such percentage shall be in lieu of all taxes on the franchise or earnings thereof.

Piltel's protest of the assessments was denied by the City of Makati on December 18, 2001. Piltel then filed a petition with the Makati RTC, appealing the local franchise business taxes. On December 10, 2002, the Makati RTC rendered its judgment granting Piltel's petition and enjoining the City of Makati from assessing and collecting any further annual local franchise business taxes from Piltel. The City of Makati filed its motion for reconsideration of this judgment with the Makati RTC, which was subsequently denied. On April 1, 2003, the City of Makati filed a Petition for Review with the Court of Appeals. On July 12, 2004, the Court of Appeals rendered a decision upholding the Makati RTC that Piltel is exempt from payment of the local franchise tax.

The City of Makati appealed to the Supreme Court, which issued a resolution dated October 13, 2004 denying with finality the appeal of the City of Makati on the grounds of technicality. The Supreme Court ruled, however, that the petition failed to sufficiently show that the Court of Appeals committed any reversible error in the questioned judgment to warrant the exercise of the discretionary appellate jurisdiction of the Supreme Court.

We have made a reasonable estimate of the amount necessary to pay or settle the contested assessment in the event of an unfavorable judgment against us and have made the appropriate provisions in our consolidated financial statements as at December 31, 2004.

***Piltel's BIR Assessment***

In 2003, the BIR issued final assessment notices, or FANs, against Piltel for deficiency taxes and penalties for taxable years 1998 and 1999, in the amounts of Php233.6 million and Php284.2 million, respectively. Piltel filed protest letters dated June 5, 2003 and September 24, 2003 with the BIR for the 1998 and the 1999 deficiency tax assessments, respectively.

With respect to the 1998 deficiency tax assessment, the BIR denied on March 16, 2003 the administrative protest filed by Piltel. On July 1, 2003, however, Piltel filed with the BIR an Application for Compromise Settlement for the 1998 deficiency tax assessments based on BIR Revenue Regulations, or RR, No. 30-2002 issued on December 16, 2002, which implements Sections 7(c), 204(a) and 290 of the National Internal Revenue Code, NIRC, of 1997 on compromise settlement of internal revenue tax liabilities, superseding RR Nos. 6-2000 and 7-2001. Under said RR 30-2003, Piltel is allowed to apply for compromise settlement on the basis of financial incapacity. If approved, Piltel would be permitted to settle its 1998 deficiency tax liabilities by paying an amount corresponding the compromise rates ranging from ten percent (10%) to forty percent (40%) of its assessed deficiency taxes for 1998. Meanwhile, with respect to the 1999 deficiency tax assessment, the BIR favorably considered the administrative protest filed by Piltel. Accordingly, the BIR issued a revised FAN dated February 17, 2004, which was received by Piltel on March 22, 2004. Hence, as early as December 31, 2003, Piltel paid and settled the 1999 expanded withholding tax assessment and the revised 1999 fringe benefit tax, or FBT, assessment amounting to Php26.1 million and Php5.6 million, respectively. On May 28, 2004, Piltel also filed with the BIR an Application for Compromise Settlement for the 1999 deficiency tax assessments, particularly the value added tax, or VAT, and income tax assessments, similarly based on RR No. 30-2002 on the grounds of financial incapacity.

Moreover, on August 5, 2004, Piltel received a Preliminary Assessment Notice, or PAN, dated July 19, 2004 in connection with Letter Notice, or LN, BOC-AID/LTS-1-41-01-02. The said LN, which is similar to a tax assessment notice, indicated a discrepancy between the importation per Bureau of Customs, or BOC, data and the importation per 2001 VAT returns amounting to Php175.5 million, which resulted in VAT and income tax deficiency assessments amounting to Php82.4 million and Php26.5 million, respectively. On August 20, 2004, Piltel filed an administrative protest in connection with the assessments. Supplemental protest letter was also filed last October 5, 2004 to further support its position against the said tax assessments after the Informal Conference held with the examiners last September 21, 2004. To date, Piltel has not received any response from the BIR. Piltel intends to apply for compromise settlement, based on the same grounds of financial incapacity, any resulting deficiency tax arising from this LN once the BIR has finalized the assessment.

***Air Time Purchase Agreement with AIL***

In March 1997, PLDT entered into a Founder NSP Air Time Purchase Agreement with PT Asia Cellular Satellite (assigned and transferred to AIL), as amended in December 1998. The agreement states that PLDT has to purchase at least US$5 million worth of air time annually over ten years commencing on the date of the Garuda satellite's commercial operations and has to make supplemental air time purchase payments not to exceed US$15 million per year during the ten-year term in the event revenues generated are less than US$45 million in any given year. The air time payment obligations shall remain in effect until all indebtedness incurred by AIL have been fully repaid. See *Note 21 - Related Party Transactions* and *Note 23 - Contractual Obligations and Commercial Commitments* for detailed discussion of the terms of the agreement.

The Garuda satellite was launched on February 12, 2000 and was available for service beginning October 1, 2000. Pre-commercial operations began on January 1, 2001 and full commercial operations began on January 1, 2002.

We believe that the payment obligations under the Air Time Purchase Agreement exceeded the economic benefits expected to be received under it as a result of the delay in the launch of the satellite, unavailability of competitive handsets and competitions from cellular services, occurrence of a partial satellite loss, changes in the primary business of AIL and other factors affecting its business. Accordingly, we started negotiations with AIL for the revision of the payment obligations under the Air Time Purchase Agreement in 2000.

As a result of these negotiations, the effective date of Air Time Purchase Agreement became January 1, 2002. In 2002, billings for satellite air time were reduced to actual air time usage, less amount for marketing assistance to service providers. In March 2003, PLDT, together with the founder NSPs, entered into a Standstill Agreement with AIL. Payments made to AIL under the Air Time Purchase Agreement based on billings of actual usage and the Standstill Agreement amounted to US$1 million in 2002, US$3.8 million in 2003 and US$0.4 million for the first quarter of 2004.

On February 10, 2004, 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 deadline set in the Standstill Agreement for the establishment of a revised Air Time Purchase Agreement. Negotiations are continuing with the relevant parties towards an amicable settlement of this matter.

On June 21, 2004, AIL also sent PLDT a letter citing PLDT in default under the Air Time Purchase Agreement for non-payment of outstanding amounts and for repudiation of its obligations thereunder. PLDT maintains, however, that the termination of the Standstill Agreement and reinstatement of the terms under the original Air Time Purchase Agreement are premature, considering that the discussions or negotiations on the terms of the proposed revised Air Time Purchase Agreement were still pending between the parties, such that it is highly inequitable for AIL to have unilaterally decided to invoke the provisions of the Standstill Agreement and declared PLDT in default. Furthermore, PLDT maintains its position that the Air Time Purchase Agreement has been rendered ineffective by various events, circumstances and technical problems encountered in the operation of the business of AIL. The substantial changes in the circumstances under which AIL must operate, changes which were not contemplated by the parties at the time the commitments were made, have rendered the commitments under the Air Time Purchase Agreement unrealistic and the performance of the same impossible.

As at December 31, 2004, PLDT's aggregate remaining minimum obligation under the original Air Time Purchase Agreement was approximately Php11,962 million.

We made a reasonable estimate of the amount necessary in the event such obligation would be settled and have made the appropriate provisions in our consolidated financial statements as at December 31, 2004 with due consideration of AIL's existing indebtedness and of PLDT's share as one of the founder NSPs. Total indebtedness of AIL amounted to US$195 million as at January 1, 2003.

## 25. Financial Assets and Liabilities

Our financial assets and liabilities are recognized initially at cost which is the fair value of the consideration given (in the case of asset) or received (in the case of a liability). Transaction costs (debt issuance costs) are included in the initial measurement of all financial assets and liabilities except for financial instruments measured at fair value through profit and loss. Subsequent to initial recognition, assets and liabilities are either valued at amortized cost using the effective interest rate method or at fair value depending on classification.

The following table sets forth the carrying values and estimated fair values of our financial assets and liabilities recognized as at December 31, 2004 and 2003. There are no material unrecognized financial assets and liabilities as at December 31, 2004 and 2003.

| | Carrying Value | | Fair Value | |
|---|---|---|---|---|
| | **2004** | 2003 | **2004** | 2003 |
| | (in million pesos) | | | |
| **Noncurrent Financial Assets** | | | | |
| Investments - available-for-sale | **104** | 117 | **104** | 117 |
| Derivative assets | **4,116** | 1,360 | **4,116** | 1,360 |
| Notes receivable | **286** | - | **286** | - |
| Total noncurrent financial assets | **4,506** | 1,477 | **4,506** | 1,477 |
| **Current Financial Assets** | | | | |
| Cash and cash equivalents | **27,321** | 19,372 | **27,321** | 19,372 |
| Short-term investments | **3,873** | 1,662 | **3,873** | 1,662 |
| Trade and other receivables | **10,404** | 16,908 | **10,404** | 16,908 |
| Derivative assets | **335** | 262 | **335** | 262 |
| Total current financial assets | **41,933** | 38,204 | **41,933** | 38,204 |
| **Total Financial Assets** | **46,439** | 39,681 | **46,439** | 39,681 |
| **Noncurrent Financial Liabilities** | | | | |
| Preferred stock subject to mandatory redemption* | **14,375** | 12,735 | **15,716** | 17,798 |
| Long-term debt - net of current portion* | **121,012** | 152,646 | **129,359** | 158,149 |
| Obligations under capital lease* | **601** | 729 | **601** | 729 |
| Derivative liabilities | **5,903** | 2,591 | **5,903** | 2,591 |
| Total noncurrent financial liabilities | **141,891** | 168,701 | **151,579** | 179,267 |
| **Current Financial Liabilities** | | | | |
| Obligations under capital lease* | **425** | 295 | **425** | 295 |
| Notes payable* | **58** | 2,133 | **58** | 2,133 |
| Accounts payable | **7,029** | 5,192 | **7,029** | 5,192 |
| Derivative liabilities | **474** | 91 | **474** | 91 |
| Current portion of long-term debt* | **28,018** | 23,810 | **28,159** | 24,611 |
| Total current financial liabilities | **36,004** | 31,521 | **36,145** | 32,322 |
| **Total Financial Liabilities** | **177,895** | 200,222 | **187,724** | 211,589 |

* Included under "Interest-bearing Financial Liabilities" in the consolidated balance sheets.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate such value:

Interest-bearing Financial Liabilities:

*Long-term debt:* Fair value is based on the following:

| Debt Type | Fair Value Assumptions |
|---|---|
| Fixed Rate Loans: | |
| U.S. dollar notes/convertible debt | Quoted market price. |
| Other loans in all other currencies | Estimated fair value is based on the discounted value of future cash flows using the applicable rates for similar types of loans. |
| Variable Rate Loans | The carrying value approximates fair value because of recent and regular repricing based on market conditions. |

*Preferred stock subject to mandatory redemption:* The fair values were determined using an independent third party valuation model.

Derivative instruments:

*Forward foreign exchange contracts and bifurcated foreign currency forwards:* The fair values were determined using forward exchange market rates at the balance sheet date.

*Foreign currency options:* The fair values were computed using an option pricing model.

*Foreign currency and interest rate swaps:* The fair values were computed as the present value of estimated future cash flows.

Due to the short-term nature of the transactions, the fair value of cash and cash equivalents, short-term investments, trade and other receivables, notes payable and accounts payable approximate amount of consideration at the time of initial recognition.

*Financial assets and liabilities carried at amortized cost*

Unamortized debt discount, representing debt issuance cost and any difference between the fair value of consideration given or received on initial recognition, included in following financial liabilities amounted to Php17,363 million and Php16,390 million as at December 31, 2004 and 2003, respectively, see *Note 18 - Interest-bearing Financial Liabilities*.

*Financial assets and liabilities carried at fair value*

The following financial assets and liabilities carried at fair value as at December 31, 2004 and 2003:

| | **2004** | 2003 |
|---|---|---|
| | (in million pesos) | |
| Investments - available-for-sale | **104** | 117 |
| Derivative instruments | **(1,926)** | (1,060) |
| | **(1,822)** | (943) |

*Derivative Financial Instruments*

Our derivative financial instruments are accounted for as either cash flow hedges or transactions not designated as hedges. Cash flow hedges refer to those transactions that hedge our exposure to variability in cash flows attributable to a particular risk associated with a recognized asset or liability. Changes in the fair value of these instruments are recognized as cumulative translation adjustments in equity until the hedged item is recognized in earnings. For transactions that are not designated as hedges, any gains or losses arising from the changes in fair value are recognized directly to income for the period.

The table below sets out the information about our derivative financial instruments as at December 31, 2004 and 2003:

| | | **2004** | | 2003 | |
|---|---|---|---|---|---|
| | **Maturity** | **Notional Amount** | **Mark-to-market Gain (Loss)** | Notional Amount | Mark-to-market Gain (Loss) |
| | | | (in millions) | | |
| ***PLDT*** | | | | | |
| Cash flow hedges: | | | | | |
| Long-term currency swaps | | | | | |
| | 2017 | **US$300** | **Php748** | US$300 | Php687 |
| | 2012 | **250** | **282** | 250 | 563 |
| | 2009[1] | **-** | **-** | 175 | 110 |
| Long-term foreign currency options | 2009 | **175** | **672** | - | - |
| Short-term foreign currency options | | **76** | **(198)** | - | - |
| Transactions not designated as hedges: | | | | | |
| Long-term foreign currency options | | **175[2]** | **(22)** | - | - |
| Short-term foreign currency options | | **-** | **-** | 79 | 247 |
| Short-term options | | **76[3]** | **117** | - | - |
| Interest rate swap | | **125** | **(3,468)** | 125 | (2,587) |
| Forward foreign exchange contracts | | **87** | **6** | 125 | (11) |
| | | **JP¥14** | **1** | - | - |
| | | | | - | - |
| Bifurcated embedded derivatives | | **US$1** | **(1)** | 3 | (12) |
| | | | **(1,863)** | | (1,003) |
| ***Smart*** | | | | | |
| Transactions not designated as hedges: | | | | | |
| Forward foreign exchange contracts | | **US$-** | **-** | US$42 | (82) |
| Bifurcated embedded derivatives | | **88** | **(63)** | 48 | 25 |
| | | | **(63)** | | (57) |
| Net liabilities | | | **(Php1,926)** | | (Php1,060) |

[1] Re-classified as long-term currency options starting July 1, 2004.
[2] Non-hedged portion of 2009 long-term foreign currency options based on the same notional amount as the hedged portion.
[3] Non-hedged portion of short-term foreign currency options based on the same notional amount as the hedged portion.

| | **2004** | 2003 |
|---|---|---|
| | (in million pesos) | |
| Presented as: | | |
| Noncurrent assets | **4,116** | 1,360 |
| Current assets | **335** | 262 |
| Noncurrent liabilities | **(5,903)** | (2,591) |
| Current liabilities | **(474)** | (91) |
| Net liabilities | **(1,926)** | (1,060) |

Cumulative translation adjustments as at December 31, 2004 and 2003 consists of:

| | 2004 | 2003 |
|---|---|---|
| | (in million pesos) | |
| Cumulative translation adjustment - beginning | **549** | 501 |
| Movement of cumulative translation adjustment | | |
| Currency translation differences | **17** | 48 |
| Net loss on cash flow hedges | **(159)** | - |
| Net loss on available-for-sale financial assets | **(5)** | - |
| Net loss on cash flow hedges removed from cumulative translation adjustments and taken to profit or loss | **(133)** | - |
| Deferred income tax effects on cash flow hedge | **93** | - |
| | **(187)** | 48 |
| Cumulative translation adjustments - ending | **362** | 549 |

Analysis of gain (loss) on derivative transaction for the years ended December 31, 2004, 2003 and 2002 are as follows:

| | 2004 | 2003 | 2002 |
|---|---|---|---|
| | | (in million pesos) | |
| Net mark-to-market loss - ending | **(1,926)** | (1,060) | (599) |
| Net mark-to-market loss - beginning | **(1,060)** | (599) | (587) |
| Net change | **(866)** | (461) | (12) |
| Net loss charged to cumulative translation adjustments | **(292)** | - | - |
| Gain (loss) on contracts entered into and terminated during the year | **167** | (64) | (74) |
| Gain on terminated interest swap agreement | **-** | - | 633 |
| Net gain (loss) on derivative transactions | **(991)** | (525) | 547 |

## *PLDT*

### *Cash Flow Hedges*

*Long-term Currency Swaps*

PLDT entered into long-term principal-only currency swap agreements with various foreign counterparties to hedge the currency risk on its fixed rate notes maturing in 2009, 2012 and 2017. As at December 31, 2004, 2003 and 2002, these long-term currency swaps have an aggregate notional amount of US$550 million, US$725 million and US$550 million, respectively. Under the swaps, PLDT effectively exchanges the principal of its U.S. dollar-denominated fixed rate notes into peso-denominated loan exposures at agreed swap exchange rates. The agreed swap exchange rates are reset to the lowest U.S. dollar/Philippine peso spot exchange rate during the term of the swaps, subject to a minimum exchange rate. In March and April 2004, PLDT entered into amendments to keep the lowest reset exchange rate and unwind the downward resettable feature of US$550 million of its long-term principal-only currency swap agreements in order to lower the running hedging cost of the swaps. As at December 31, 2004, 2003 and 2002, the outstanding swap contracts have an average exchange rate of Php50.76, Php51.22 and Php51.27, respectively.

In order to manage hedge costs, these swaps included credit-linkage feature with PLDT as the reference entity. The specified credit events include bankruptcy, failure to pay, obligation acceleration, moratorium/repudiation, and restructuring of PLDT bonds or all or substantially all of PLDT's obligations. Upon the occurrence of any of these credit events, subject to agreed threshold amounts where applicable, the obligations to both PLDT and its counterparty under the swap contracts terminate without further settlements to either party, including any mark-to-market value of the swaps. In March 2004, PLDT amended an additional US$150 million of the long-term currency swaps to include this credit-linkage feature. As at December 31, 2004, 2003 and 2002, US$725 million, US$575 million and US$400 million of PLDT's long-term currency swaps/options, respectively, have been structured to include credit-linkage with PLDT as the reference entity. The semi-annual fixed or floating swap cost payments that PLDT is required to make to its counterparties averaged to about 2.95%, 2.10% and 2.35% per annum as at December 31, 2004, 2003 and 2002, respectively. As cash flow hedges, any movements in the fair value of these instruments will be taken as a cumulative translation adjustment under equity in our consolidated balance sheets.

*Long-term Currency Options*

To manage hedging costs, the currency swap agreement relating to the 2009 fixed rate notes has been structured to include currency option contracts. If the Philippine peso to U.S. dollar spot exchange rate on maturity date settles beyond Php90.00 to US$1.00, PLDT will have to purchase U.S. dollar at an exchange rate of Php52.50 to US$1.00 plus the excess above the agreed threshold rate. On the other hand, if on maturity, the Philippine peso to US$1.00 spot exchange rate is lower than the exchange rate of Php52.50 to US$1.00, PLDT will have the option to purchase at the prevailing Philippine peso to U.S. dollar spot exchange rate. In July 2004, PLDT and its counterparty, agreed to re-document and re-classify the transaction into long-term currency option contracts. The net semi-annual floating hedge cost payments that PLDT is required to pay under these transactions was approximately 3.94% and 2.30% per annum as at December 31, 2004 and 2003, respectively.

The option currency contract relating to PLDT's option to purchase U.S. dollar at Php52.50 to US$1.00 or prevailing spot rate at maturity whichever is lower, qualifies as a cash flow hedge. The option currency contract relating to the counterparty's option to purchase foreign currency from PLDT at Php90.00 to US$1.00 is not designated as a hedge. Please refer to discussion below (under transactions not designated as hedges).

*Short-term Currency Options*

PLDT utilized structures incorporating currency options to hedge the maturing principal on its fixed rate notes due June 2004 and June 2005. Under the terms of the contracts, PLDT will have the option to purchase U.S. dollar at an agreed Philippine peso to U.S. dollar spot exchange rate or prevailing spot rate at maturity whichever is lower.

***Transactions Not Designated as Hedges***

Due to the amounts of PLDT's foreign currency hedging requirements and the large interest differential between the Philippine peso and the U.S. dollar, the costs to book long-term hedges can be significant. In order to manage such hedging costs, PLDT utilizes structures that include currency option contracts, and fixed-to-floating coupon-only swaps that may not qualify for hedge accounting.

*Long-term Currency Options*

With reference to the above-mentioned hedge on the PLDT's 2009 fixed rate notes, PLDT simultaneously sold a currency option contract with the same notional amount of US$175 million with the same maturity that gives the counterparty a right to purchase foreign currency at Php90.00 to US$1.00. Together with the long-term currency option contract classified under cash flow hedges, PLDT has the obligation to purchase U.S. dollar at an exchange rate of Php52.50 to US$1.00 plus the excess above the agreed threshold rate. In exchange for this condition, the overall net hedging cost for the transaction is reduced.

*Short-term Currency Options*

In order to manage hedge costs, currency option contracts that hedge PLDT's fixed rate notes due June 2004 and June 2005 have features similar to that of the long-term currency option contracts. PLDT simultaneously sold currency option contracts with the same notional amounts with same maturity. Together with the other short term currency option contracts classified under cash flow hedges, PLDT has the obligation to buy U.S. dollar at the agreed strike price plus the excess above the agreed threshold rate should the Philippine peso to U.S. dollar spot exchange rate on maturity date settle beyond that agreed threshold. In exchange for this condition, the overall net hedging cost for the transactions is reduced.

PLDT also entered into short-term U.S. dollar subsidized forwards and Japanese yen currency option contracts to hedge other short-term foreign currency obligations.

*Interest Rate Swap*

A portion of PLDT's currency swap agreements to hedge its 2017 fixed rate notes carry fixed rate swap cost payments. To effectively lower the running cost of such swap agreements, PLDT, in April 2003, entered into an agreement to swap the coupon on US$125 million of its 2012 fixed rate notes into a floating rate Japanese yen amount. Under this agreement, PLDT is entitled to receive a fixed coupon rate of 11.375% provided the Japanese yen to U.S. dollar exchange rate stays above JP¥99.90/US$1.00. Below this level, a reduced fixed coupon rate of 3% will be due to PLDT. In order to mitigate the risk of the Japanese yen strengthening below the agreed threshold, PLDT, in December 2003, entered into an overlay swap transaction to effectively lower the portion of the coupon indexed to the U.S. dollar to Japanese yen rate to 3%. Both swap agreements include a credit-linkage feature with PLDT as the reference entity.

*Forward Foreign Exchange Contracts*

PLDT entered into short-term U.S. dollar and Japanese yen forward foreign exchange contracts to hedge short-term foreign currency obligations.

*Bifurcated Embedded Derivatives*

Derivative instruments include derivatives (or derivative-like provisions) embedded in non-derivative contracts. PLDT's outstanding bifurcated embedded derivative transactions cover service contracts denominated in U.S. dollars to be paid out to a Japanese company.

### *Smart*

Smart uses forward exchange contracts to hedge foreign currency-denominated assets, liabilities and firm commitments. These forward contracts have maturities ranging from one to six months.

Cash deposits, presented as prepayment for forward purchase contract under "Short-term Investment", amounting to Php3,873 million and Php1,662 million collateralize certain of the forward exchange contracts outstanding as at December 31, 2004 and 2003, respectively. The embedded foreign currency derivatives bifurcated from these prepaid forwards are presented as derivative assets or derivative liabilities.

Smart's other embedded derivatives were bifurcated from service and purchase contracts. As at December 31, 2004 and 2003, outstanding contracts included a service contract with foreign equipment supplier and various suppliers covering handset importations payable in U.S. dollars.

**Financial Risk Management Objectives and Policies**

The main purpose of our financial instruments is to fund our operations. We also enter into derivative transactions, the purpose of which is to manage the currency risks and interest rate risks arising from our operations and our sources of financing. It is, and has been throughout the year under review, our policy that no trading in financial instruments shall be undertaken.

The main risks arising from our financial instruments are liquidity risk, foreign currency risk, interest rate risk and credit risk. Our Board reviews and agrees with policies for managing each of these risks and they are summarized below. We also monitor the market price risk arising from all financial instruments. Our accounting policies in relation to derivatives are set out in *Note 2 - Summary of Significant Accounting Policies*.

***Liquidity Risk***

We seek to manage our liquidity profile to be able to finance our capital expenditures and service our maturing debts. To cover our financing requirements, we intend to use internally generated funds and proceeds from debt and equity issues and sales of certain assets.

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

***Foreign Currency Risk***

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

| | **2004** | | 2003 | |
|---|---|---|---|---|
| | **U.S. Dollar**[1] | **Php Equivalent** | U.S. Dollar[2] | Php Equivalent |
| | (in millions) | | | |
| **Noncurrent Financial Assets** | | | | |
| Derivative assets | **US$73** | **Php4,113** | US$24 | Php1,334 |
| Notes receivable | **5** | **286** | - | - |
| Total noncurrent financial assets | **78** | **4,399** | 24 | 1,334 |
| **Current Financial Assets** | | | | |
| Cash and cash equivalents | **251** | **14,142** | 146 | 8,116 |
| Short-term investments | **69** | **3,888** | 30 | 1,668 |
| Trade and other receivables | **146** | **8,226** | 195 | 10,839 |
| Derivative assets | **6** | **338** | 5 | 277 |
| Total current financial assets | **472** | **26,594** | 376 | 20,900 |
| **Total Financial Assets** | **US$550** | **Php30,993** | US$400 | Php22,234 |
| **Noncurrent Financial Liabilities** | | | | |
| Interest-bearing financial liabilities | **US$2,330** | **Php131,275** | US$2,772 | Php156,177 |
| Derivative liabilities | **105** | **5,916** | 47 | 2,612 |
| Total noncurrent financial liabilities | **2,435** | **137,191** | 2,819 | 158,789 |
| **Current Financial Liabilities** | | | | |
| Accounts payable | **46** | **2,592** | 71 | 3,947 |
| Accrued expenses and other current liabilities | **77** | **4,338** | 71 | 3,947 |
| Derivative liabilities | **8** | **451** | 2 | 111 |
| Interest-bearing financial liabilities | **483** | **27,213** | 405 | 22,512 |
| Total current financial liabilities | **614** | **34,594** | 549 | 30,517 |
| **Total Financial Liabilities** | **US$3,049** | **Php171,785** | US$3,368 | Php189,306 |

[1] The exchange rate used was Php56.341 to US$1.00.
[2] The exchange rate used was Php55.586 to US$1.00.

In translating the foreign currency-denominated monetary assets and liabilities into peso amounts, the exchange rates used were Php56.341 to US$1.00 and Php55.586 to US$1.00, the Philippine peso-U.S. dollar exchange rates as at December 31, 2004 and 2003, respectively.

As at February 28, 2005, the peso-dollar exchange rate was Php54.685 to US$1.00. Using this exchange rate, our consolidated net foreign currency-denominated liabilities as at December 31, 2004 would have decreased by Php5,031 million.

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

As at December 31, 2004, approximately 98% of our total consolidated debts were denominated in foreign currencies. Of our foreign currency-denominated debts, 4% are in Japanese yen, and the balance in U.S. dollars. Thus, a weakening of the peso against the U.S. dollar or Japanese yen will increase both the principal amount of our unhedged foreign currency-denominated debts (representing 64% of our consolidated foreign-currency debts), and interest expense on our debt in peso terms. In addition, many of our financial ratios and other financial tests will be negatively affected. If, among other things, the value of the peso against the U.S. dollar substantially drops from its current level, we may be unable to maintain compliance with these ratios, which could result in acceleration of some or all of our indebtedness. For further information on our loan covenants, see *Note 18 - Interest-bearing Financial Liabilities* to the accompanying consolidated financial statements.

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

Specifically, we use forward foreign exchange contracts, foreign currency swap contracts and currency option contracts to manage the foreign exchange risk associated with our foreign currency-denominated loans.

***Interest Rate Risk***

On a limited basis, we enter into interest rate swap agreements in order to manage our exposure to interest rate fluctuations. We make use of hedging instruments and structures solely for reducing or managing financial risks associated with our liabilities and not for trading or speculative purposes.

The following table sets out the carrying amount, by maturity, of our financial instruments that are exposed to interest rate risk:

***Year Ended December 31, 2004***

| | Below 1 year | 1-2 years | 2-3 years | 3-5 years | Over 5 years | In U.S. Dollar | In Php | Discount/ Debt Issuance Cost In Php | Carrying Value In Php | Fair Value In U.S. Dollar | Fair Value In Php |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | (in millions) | | | |
| **Liabilities:** | | | | | | | | | | | |
| Long-term Debt | | | | | | | | | | | |
| *Fixed Rate* | | | | | | | | | | | |
| US$ Notes (in millions) | 110 | 130 | 272 | 175 | 550 | 1,237 | 69,725 | 930 | 68,795 | 1,307 | 73,662 |
| Interest rate | 9.875% | 9.25% | 7.85% to 10.625% | 10.5% | 8.35% to 11.375% | - | - | - | - | - | - |
| US$ Fixed Loans (in millions) | 86 | 71 | 65 | 103 | 282 | 607 | 34,190 | 7,340 | 26,850 | 576 | 32,452 |
| Interest rate | 4.49% to 8.03% | 4.49% to 7.75% | 4.49% to 7.95% | 4.49% to 7.89% | 2.25% to 6.56% | - | - | - | - | - | - |
| Japanese Yen (in millions) | - | - | - | 95 | - | 95 | 5,363 | | 5,363 | 96 | 5,414 |
| Interest rate | - | - | - | 2.125% | - | - | - | - | - | - | - |
| Philippine Peso (in millions) | 14 | 14 | - | - | 14 | 42 | 2,371 | 5 | 2,366 | 45 | 2,537 |
| Interest rate | 11.18% to 14% | 11.6% to 24% | - | - | 15% | - | - | - | - | - | - |
| *Variable Rate* | | | | | | | | | | | |
| U.S. Dollar (in millions) | 119 | 165 | 157 | 99 | 273 | 813 | 45,832 | 2,045 | 43,787 | 814 | 45,832 |
| Interest rate | 0.20% over CXC's cost to 3.25% over LIBOR | 0.425% to 3.25% over LIBOR | 0.20% over CXC's cost to 3.25% over LIBOR | 0.15% to 4.30% over LIBOR | 0.5% to 3.625% over LIBOR | - | - | - | - | - | - |
| Japanese Yen (in millions) | - | - | - | 22 | - | 22 | 1,212 | - | 1,212 | 22 | 1,212 |
| Interest rate | - | - | - | 1.7% over JP¥ LIBOR | - | - | - | - | - | - | - |
| Philippine Peso (in millions) | 2 | 2 | 2 | 1 | 7 | 14 | 777 | 120 | 657 | 13 | 777 |
| Interest rate | 1% over 91-day T-bill rate to 11.25% | 1% over 91-day T-bill rate to 11.25% | 1% over 91-day T-bill rate to 11.25% | 1% over 91-day T-bill rate | 1% over 91-day T-bill rate | - | - | - | - | - | - |
| | | | | | | **2,830** | **159,470** | **10,440** | **149,030** | **2,873** | **161,886** |
| *Interest rate swap (fixed to floating)* | | | | | | | | | | | |
| U.S. Dollar (US$125 million) | - | - | - | - | - | (62) | (3,468) | - | - | (62) | (3,468) |
| Japanese Yen (JP¥15,037 million) | - | - | - | - | - | - | - | - | - | - | - |
| Fixed Rate on US$ notional | - | - | - | - | 11.375% | - | - | - | - | - | - |
| Variable Rate on JP¥ notional | - | - | - | - | 8.11% over LIBOR | - | - | - | - | - | - |

***Year Ended December 31, 2003***

| | Below 1 year | 1-2 years | 2-3 years | 3-5 years | Over 5 years | In U.S. Dollar | In Php | Discount/ Debt Issuance Cost In Php | Carrying Value In Php | Fair Value In U.S. Dollar | Fair Value In Php |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | (in millions) | | | |
| **Liabilities:** | | | | | | | | | | | |
| Long-term Debt | | | | | | | | | | | |
| *Fixed Rate* | | | | | | | | | | | |
| US$ Notes (in millions) | 77 | 138 | 175 | 300 | 725 | 1,415 | 78,666 | 787 | 77,879 | 1,444 | 80,273 |
| Interest rate | 10.625% | 9.875% | 9.25% | 7.85% to 10.625% | 8.35% to 11.375% | - | - | - | - | - | - |
| US$ Fixed Loans (in millions) | 60 | 90 | 48 | 119 | 19 | 336 | 18,723 | 250 | 18,473 | 319 | 19,974 |
| Interest rate | 5.60% to 8.01% | 5.60% to 8.03% | 5.60% to 7.75% | 6.6% to 7.95% | 5.65% to 6.56% | - | - | - | - | - | - |
| Japanese Yen (in millions) | - | - | - | 91 | - | 91 | 5,068 | - | 5,068 | 92 | 5,120 |
| Interest rate | - | - | - | 2.125% | - | - | - | - | - | - | - |
| Philippine Peso (in millions) | 14 | 30 | 14 | - | 15 | 73 | 4,043 | 19 | 4,024 | 79 | 4,385 |
| Interest rate | 12.81% to 17.5% | 11.18% to 16.8% | 15.816% to 16.8% | - | 15% | - | - | - | - | - | - |
| *Variable Rate* | | | | | | | | | | | |
| U.S. Dollar (in millions) | 82 | 162 | 210 | 274 | 338 | 1,066 | 59,337 | 4,194 | 55,143 | 1,024 | 59,337 |
| Interest rate | 0.425% to 3.25% over LIBOR | 0.425% to 3.25% over LIBOR | 0.425% to 3.65% over LIBOR | 0.15% to 4.30% over LIBOR | 0.65% to 3.625% over LIBOR | - | - | - | - | - | - |
| Japanese Yen (in millions) | - | - | 103 | 15 | 130 | 248 | 13,792 | 1,342 | 12,450 | 248 | 13,792 |
| Interest rate | - | - | 3.85% over JP¥ LIBOR | 1.0% over JP¥ LIBOR | 1.0% over JP¥ LIBOR | - | - | - | - | - | - |
| Philippine Peso (in millions) | 1 | 1 | 1 | 8 | 74 | 85 | 4,731 | 1,312 | 3,419 | 85 | 4,731 |
| Interest rate | 1.0% over 91-day T-bill rate to 11% | 1.0% over 91-day T-bill rate to 11% | 1.0% over 91-day T-bill rate | 1.0% over 91-day T-bill rate | 1.0% over 91-day T-bill rate | - | - | - | - | - | - |
| | | | | | | **3,314** | **184,360** | **7,904** | **176,456** | **3,291** | **187,612** |
| *Interest rate swap (fixed to floating)* | | | | | | | | | | | |
| Japanese Yen (JP¥15,037 million) | - | - | - | - | - | (46) | (2,582) | - | - | (46) | (2,582) |
| Fixed Rate on US$ notional | - | - | - | - | 11.375% | - | - | - | - | - | - |
| Variable Rate on JP¥ notional | - | - | - | - | 8.16% over LIBOR | - | - | - | - | - | - |

Fixed rate financial instruments are subject to fair value interest rate risk while floating rate financial instruments are subject to cash flow interest rate risk.

Repricing of floating rate financial instruments is mostly done on intervals of three months or six months. Interest on fixed rate financial instruments is fixed until maturity of instrument. Financial instruments that are not subject to interest rate risk were not included in the above tables.

***Credit Risk***

We trade only with recognized, creditworthy third parties. It is our policy that all customers who wish to trade on credit terms are subject to credit verification procedures. In addition, receivable balances are monitored on an ongoing basis to reduce our exposure to bad debts.

With respect to credit risk arising from our other financial assets, which comprise cash and cash equivalents, certain derivative instruments, our exposure to credit risk arises from default of the counterparty, with a maximum exposure equal to the carrying amount of these instruments.

We have no significant concentrations of credit risk.

## 26. Other Matters

***a. Interconnection Agreements***

PLDT has existing interconnection agreements with nine International Gateway Facilities, or IGF operators, six Inter Exchange Carriers, or IXCs, six Cellular Mobile Telephone Systems, or CMTS operators, 70 LECs (including members of the Philippine Association of Private Telephone Companies, Inc.), and 12 paging and trunk radio operators. These interconnection agreements include provisions for settlement and payment of charges. Settlements with interconnecting IGF operators and CMTS operators for local calls are in the form of access charges. Settlement with interconnecting IXCs and LECs for toll calls are based on hauling and access charges, and to some extent, revenue sharing. Settlement also involves payment of access charges, but settlement for toll calls is on a revenue-sharing basis. LEC to LEC interconnection with hauling from one service area to another service area is settled based on trunk charges, while overlay LEC to LEC interconnection in a given service area is without charges. Paging and trunk radio interconnection settlements are based on fixed charges.

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

Effective as at February 1, 2003, PLDT stopped terminating traffic sent directly by each of AT&T and MCI, because PLDT's termination rate agreements with AT&T and MCI lapsed in December 2002 without either agreeing with PLDT on any provisional arrangement or final agreement on new termination rates. In orders dated February 7 and 26, 2003, the NTC confirmed that "absent any provisional or interim agreement" with U.S. carriers, there would be no provision of termination services between the parties "who are thereby encouraged to seek other routes or options to terminate traffic to the Philippines". Upon petitions of AT&T and MCI, on March 10, 2003, the International Bureau of the U.S. FCC issued an Order which directed all facilities-based carriers subject to U.S. FCC jurisdiction to suspend payments for termination services to Philippine carriers, including PLDT, Smart and Subic Telecom, until such time as the U.S. FCC issued a Public Notice that AT&T's and MCI's circuits on the U.S.-Philippine route were fully restored. The Order also removed the Philippines from the list of U.S.-international routes approved for the provision of International Simple Resale, or ISR. In response to the International Bureau's Order, the NTC issued a Memorandum Order dated March 12, 2003, directing all affected Philippine carriers "(1) not to accept terminating traffic via direct circuits from U.S. facilities-based carriers who do not pay Philippine carriers for services rendered; and (2) to take all measures necessary to collect payments for services rendered in order to preserve the viability, efficiency, sustained growth and development and continued competitiveness of the Philippine telecommunications industry".

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

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

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

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

Although not included in the initial list of countries exempted from the U.S. FCC's International Settlements Policy, or ISP, the U.S. FCC identified the U.S.-Philippines route as eligible for being removed from the ISP in accordance with its newly established procedures for doing so. Under this procedure, the U.S. FCC asked for public comment on the removal of the Philippines from the ISP. In comments filed in June and July 2004, removal was reported by several Philippine and U.S. carriers, including AT&T and MCI, and was opposed by one U.S. carrier, International Access, Inc. In November 2004, the U.S. FCC exempted a number of additional countries from the ISP, but not the Philippines. Instead, the U.S. FCC stated that it would rule separately regarding the Philippines after reviewing the issues raised by International Access, Inc. These issues are still pending before the U.S. FCC.

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

***c. Investigation by the U.S. Department of Justice***

In January 2004, PLDT received a grand jury subpoena seeking documents and a PLDT employee was subpoenaed to testify before the grand jury in connection with a criminal investigation being conducted by the U.S. Department of Justice with respect to alleged antitrust violations relating to the provision of international termination services in the Philippines. The U.S. Department of Justice has also requested testimony and documents from Smart in connection with this investigation. Further, in March 2004, PLDT (U.S.) Ltd., a subsidiary of PLDT Global, received a grand jury subpoena seeking documents, in response to which PLDT (U.S.) Ltd. produced documents. In February 2005, two former employees of PLDT U.S. Ltd. testified before the grand jury in the U.S. DOJ matter. A PLDT employee was also scheduled to reappear for testimony in February, but his appearance has been postponed. At this time, the PLDT Group cannot predict the outcome of this investigation.

# REGISTRARS, TRANSFER AGENTS AND DEPOSITARY

## Registrars and Transfer Agents

### COMMON CAPITAL STOCK

**Philippine Registrar and Transfer Agent**

The Hongkong and Shanghai Banking Corporation Limited
30/F, Discovery Suites
#25 ADB Avenue, Ortigas Center
Pasig City, Philippines
Telephone: (632) 683-2687
(632) 683-2680
(632) 683-2689

### SERIAL PREFERRED STOCK

**10% CUMULATIVE CONVERTIBLE PREFERRED STOCK - SERIES A TO Z AND SERIES AA TO FF**

**SERIES IV REDEEMABLE NON-CONVERTIBLE PREFERRED STOCK**

Rizal Commercial Banking Corporation
9th Flr., RCBC Plaza, Yuchengco Tower 1
Ayala Avenue corner Sen. Gil Puyat Avenue
Makati City, Philippines
Telephone: (632) 894-9000

**SERIES V, VI AND VII CONVERTIBLE PREFERRED STOCK**

The Hongkong and Shanghai Banking Corporation Limited
30/F, Discovery Suites
#25 ADB Avenue, Ortigas Center
Pasig City, Philippines
Telephone: (632) 683-2687
(632) 683-2680
(632) 683-2689

## Depositary of American Depositary Shares and Global Depositary Shares

### AMERICAN DEPOSITARY RECEIPTS

### SERIES III CONVERTIBLE PREFERRED STOCK

JPMorgan Chase Bank, N.A.
JPMorgan Shareholder Service Center
P.O. Box 43013
Providence, RI 02940-3013
U.S. Domestic Toll Free: (1-800) 990-1135
International Telephone No.: (1-781) 575-4328
Fax No.: (1-781) 575-4088
Email address: adr@jpmorgan.com
Website: www.adr.com

The Common Capital Stock of PLDT is listed on the Philippine Stock Exchange (ticker: TEL). PLDT has also established an American Depositary Receipt facility under which American Depositary Shares (ticker: PHI) representing shares of Common Capital Stock are listed and traded on the New York Stock Exchange and Pacific Exchange. The American Depositary Shares are evidenced by American Depositary Receipts issued by the Depositary. On February 10, 2003, JPMorgan Chase Bank has been appointed as the successor depositary under the Common Stock Deposit Agreement dated October 19, 1994, as amended on February 10, 2003.

The Series A to Z and Series AA to FF 10% Cumulative Convertible Preferred Stock of PLDT are listed on the Philippine Stock Exchange.

PLDT has established a Global Depositary Receipt facility under which Global Depositary Shares representing shares of the Series III Convertible Preferred Stock are listed and traded on the New York Stock Exchange (ticker: PHI PRA). The Global Depositary Shares are evidenced by Global Depositary Receipts issued by the Depositary. On February 10, 2003, JPMorgan Chase Bank has been appointed as the successor depositary under the Preferred Stock Deposit Agreement dated November 29, 1994, as amended on September 6, 1999 and February 10, 2003.

**For inquiries, please contact:**
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PLDT's Corporate Governance Manual, Code of Ethics and NYSE Section 303A.11 Disclosure, which summarizes the differences between PLDT's corporate governance practices and those required of U.S. companies listed on the NYSE, may be downloaded from:

Code of Corporate Governance -
http://www.pldt.com.ph/download/pldt-corpgov_manual.pdf

Code of Ethics -
http://www.pldt.com.ph/download/pldt-code_ethics.pdf

NYSE Section 303A.11 Disclosures -
http://www.pldt.com.ph/download/pldt-disclosure.pdf