

HUNGARIAN TELECOMMUNICATIONS CO LTD MATAV  
Form 20-F  
May 11, 2004

[QuickLinks](#) -- Click here to rapidly navigate through this document

As filed with the Securities and Exchange Commission on May 11, 2004

---

## SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

---

### Form 20-F

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2003  
Commission file number 1-14540

---

## MAGYAR TÁVKÖZLÉSI RT.

*(Exact Name of Registrant as Specified in Its Charter)*

## HUNGARIAN TELECOMMUNICATIONS CO. LTD.

*(Translation of Registrant's Name Into English)*

### Hungary

*(Jurisdiction of Incorporation or Organization)*

### Budapest, 1013, Krisztina krt. 55, Hungary

*(Address of Principal Executive Offices)*

Securities registered or to be registered pursuant to Section 12(b) of the Act

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
American Depositary Shares, each representing five Ordinary Shares	New York Stock Exchange
Ordinary Shares	New York Stock Exchange*
Securities registered or to be registered pursuant to Section 12(g) of the Act	

**NONE**  
**(Title of Class)**

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act

**NONE**  
**(Title of Class)**

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares.....1,042,811,600  
nominal value HUF 100 per share  
(as of December 31, 2003)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Edgar Filing: HUNGARIAN TELECOMMUNICATIONS CO LTD MATAV - Form 20-F

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

YES                        NO           

Item 17                        Item 18              
\*Not for trading, but only in connection with the registration of American Depositary Shares.

---

---

---

## TABLE OF CONTENTS

	<b>Page</b>
<b>PART I</b>	
Item 1	1
Item 2	1
Item 3	2
	2
	6
Item 4	12
	12
	12
	12
	13
	14
	18
	18
	33
	38
	40
	45
	48
	48
	49
	54
	58
	59
	61
	62
	62
	68
	69
	69
	72
Item 5	73
	74
	74
	76
	88
	92
	96
	96
	97
	98
	99
	100
Item 6	102
	102
	105

	Supervisory Board	107
	Indemnification of the Board of Directors and the Supervisory Board	109
	Compensation of Directors and Officers	110
	Board Practices	110
	Employees	111
	Share Ownership of Management	112
Item 7	Major Shareholders and Related Party Transactions	113
	Major Shareholders	113
	Related Party Transactions	114
Item 8	Financial Information	116
	Consolidated Financial Statements	116
	Other Financial Information	116
	Legal proceedings	116
	Dividend Policy	120
	Significant Changes	120
Item 9	The Offer and Listing	121
Item 10	Additional Information	123
	Share Capital	123
	Option to Purchase Securities from Registrant or Subsidiaries	123
	Memorandum and Articles of Association	125
	Significant Differences in Corporate Governance Practices for Purposes of Section 303A.11 of the New York Stock Exchange Listed Company Manual	130
	Material Contracts	133
	Exchange Control	134
	Taxation	135
	Documents on Display	137
Item 11	Quantitative and Qualitative Disclosures About Market Risk	138
Item 12	Description of Securities Other than Equity Securities	139

## PART II

Item 13	Defaults, Dividend Arrearages and Delinquencies	140
Item 14	Material Modifications to the Rights of Security Holders and Use of Proceeds	140
Item 15	Controls and Procedures	140
Item 16A	Audit Committee Financial Expert	140
Item 16B	Code of Ethics	140
Item 16C	Principal Accountant Fees and Services	141
Item 16D	Exemptions from the Listing Standards for Audit Committees	142
Item 16E	Purchases of Equity Securities by the Issuer and Affiliated Purchasers	142

## PART III

Item 17	Financial Statements	142
Item 18	Financial Statements	142
Item 19	Exhibits	142

### **Certain Defined Terms and Conventions**

In this annual report, the terms "Matáv", the "Group", the "Company", "we", "us" and "our" refer to Matáv Rt. and its direct and indirect subsidiaries as a group; the term "Westel" refers to Westel Mobil Távközlési Rt.; the term "Westel 0660" refers to Westel Rádiótelefon Kft. and the term "MakTel" refers to Makedonski Telekomunikacii AD. In this annual report, the term "Minister" refers to the Minister heading the Ministry of Informatics and Communications, to whom the rights of the Prime Minister Office were transferred as of May 27, 2002. The rights belonging to the Prime Minister Office belonged to the Ministry of Transport, Telecommunications and Water Management prior to June 1, 2000.

Totals in tables may be affected by rounding. Segment revenue and operating expense figures included in this annual report do not give effect to intersegment eliminations.

### **Forward-looking Statements May Not Be Accurate**

The Company may from time to time make written or oral forward-looking statements. Written forward-looking statements appear in documents the Company files with the Securities and Exchange Commission, including this annual report, reports to shareholders and other communications. The U.S. Private Securities Litigation Reform Act of 1995 contains a safe harbor for forward-looking statements. Factors identified in filings with the Commission may cause actual results to differ materially from a forward-looking statement made by Matáv or on its behalf. Readers should also consider the information contained in Item 3, "Key Information Risk Factors" and Item 5, "Operating and Financial Review and Prospects", as well as the information contained in the Company's periodic filings with the Securities and Exchange Commission for further discussion of the risks and uncertainties that may cause such differences to occur. The Company's forward-looking statements speak only as of the date they are made, and the Company does not have an obligation to update or revise them, whether as a result of new information, future events or otherwise.

**PART I**

**ITEM 1 IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2 OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

## ITEM 3 KEY INFORMATION

## SELECTED FINANCIAL DATA

This selected consolidated financial and statistical information should be read together with the consolidated financial statements, including the accompanying notes, included in this annual report. Matáv derived the financial data from Matáv's consolidated financial statements as of and for the years ended December 31, 1999, 2000, 2001, 2002 and 2003 and the accompanying notes, which have been audited by PricewaterhouseCoopers Könyvvizsgáló és Gazdasági Tanácsadó Kft. These consolidated financial data are qualified by reference to Matáv's consolidated financial statements and accompanying notes, which the Company has prepared in accordance with International Financial Reporting Standards ("IFRS"). IFRS differs from U.S. Generally Accepted Accounting Principles ("GAAP"). For a discussion of the principal differences between IFRS and U.S. GAAP as they relate to the Company, see Note 35 to the consolidated financial statements.

## Year ended December 31,

	1999	2000 (3)	2001 (3)	2002	2003	2003
	HUF	HUF	HUF	HUF	HUF	U.S.\$ (1)

(in millions, except per share amounts)

**Consolidated Income Statement Data:**

## Amounts in accordance with IFRS

Revenues	384,932	445,945	547,735	590,585	607,252	2,921
Operating profit	121,131	96,091	119,400	122,240	122,064	587
Net income	78,632	66,652	82,560	68,128	57,475	277
Net income per share (2)	75.81	64.27	79.59	65.66	55.38	0.27
Diluted net income per share (2)	75.52	63.97	79.59	65.66	55.38	0.27

## Amounts in accordance with U.S. GAAP

Revenues	385,306	461,537	550,900	592,294	610,946	2,938
Operating profit	121,460	90,456	120,144	132,585	132,715	638
Net income	78,721	64,508	82,231	78,153	66,104	318
Net income per share (2)	75.89	62.20	79.30	75.32	63.69	0.31
Diluted net income per share (2)	75.61	61.91	79.30	75.32	63.69	0.31

**Consolidated Balance Sheet Data:**

## Amounts in accordance with IFRS

Total assets	647,870	954,424	1,104,196	1,077,451	1,058,837	5,092
Net assets	350,591	638,509	508,469	575,580	630,384	3,032
Capital stock	103,728	103,736	103,736	104,281	104,281	502
Total shareholders' equity	327,579	637,281	460,300	516,144	560,110	2,695

## Amounts in accordance with U.S. GAAP

Total assets	647,239	962,379	1,114,742	1,096,006	1,086,487	5,226
Net assets	338,260	624,168	490,084	566,913	629,962	3,030
Total shareholders' equity	315,248	622,941	445,167	511,036	563,631	2,711

## Year ended December 31,

	1999	2000	2001	2002	2003
--	------	------	------	------	------

**Other data:**

## Weighted average number of shares (millions)

Basic	1,037	1,037	1,037	1,038	1,038
Diluted	1,041	1,042	1,037	1,038	1,038

- (1) Translated into U.S. dollars at the official closing rate of the National Bank of Hungary on December 31, 2003 of U.S. dollar 1.00 = HUF 207.92. These translations are unaudited and presented for convenience purposes only.
- (2) Net income per share under IFRS and net income per share under U.S. GAAP are calculated by dividing net income by the weighted average number of shares outstanding during each period.
- (3) In December 2001 the Company acquired 49 percent of the common shares of Westel and Westel 0660 ("the Westels") from Deutsche Telekom AG. The Company is controlled by Deutsche Telekom AG so this was a transaction between parties under common control. The financial statements have been restated as if the Westels were wholly owned subsidiaries of Matáv since March 23, 2000, the date when Deutsche Telekom AG acquired 49 percent of the Westels.

**Dividends**

The following table sets forth the dividend per Matáv ordinary share for the years 1999, 2000, 2001, 2002 and 2003. The table shows the dividend amounts in Hungarian forints, together with U.S. dollar equivalents, for each of the years indicated.

Year	Dividend Paid Per Ordinary Share	
	HUF	U.S.\$ (1)
1999	9	0.0356
2000	10	0.0351
2001	11	0.0394
2002	18	0.0799
2003	70	0.3367

- (1) Translated into U.S. dollars at the official closing rate of the National Bank of Hungary on December 31, 2003 of U.S. dollar 1.00 = HUF 207.92, December 31, 2002 of U.S. dollar 1.00 = HUF 225.16, December 31, 2001 of U.S. dollar 1.00 = HUF 279.03, on December 31, 2000 of U.S. dollar 1.00 = HUF 284.73 and on December 31, 1999 of U.S. dollar 1.00 = HUF 252.52.

**Exchange Rate Information**

The National Bank of Hungary sets the official rate of exchange for Hungarian forint. Until December 31, 1998, the rate was based on a basket of currencies consisting of 30 percent U.S. dollars and 70 percent Deutsche marks. On January 1, 1999, the National Bank of Hungary replaced the Deutsche mark with the euro to change the currency basket to 30 percent U.S. dollars and 70 percent Euros. On January 1, 2000, the National Bank of Hungary removed the U.S. dollars from the basket and based the Hungarian forint solely on the euro.

On March 12, 1995, the National Bank of Hungary announced a crawling peg system for devaluing the Hungarian forint against a basket of foreign currencies. Under the crawling peg devaluation regime, the Hungarian forint was devalued each day by a fixed percentage rather than intermittently. The National Bank of Hungary determined and announced in advance the monthly rate of devaluation.



On any given day, the actual exchange rate of the Hungarian forint against the basket of currencies may vary from the rate the National Bank of Hungary has announced. Before May 4, 2001, the National Bank of Hungary had stated a policy of intervening in the foreign currency market if the actual exchange rate moves more than 2.25 percent above or below the announced rate. On May 4, 2001, the National Bank of Hungary announced that it has widened this intervention band significantly to 15 percent above or below the announced rate. The move was explained as a step towards convergence with the European Union exchange rate regime and as an effective tool to fight inflation. Matáv's exposure to risks from exchange rate fluctuations has increased as a result of this band widening because the National Bank of Hungary is less likely to act to stabilize the value of the Hungarian forint during periods of exchange rate volatility. In October 2001, the crawling peg system ceased to exist. The middle of the intervention band was set at 276.1 HUF/EUR. On June 4, 2003 the midpoint of the intervention band was shifted to 282.36 HUF/EUR with the aim to improve the long term competitiveness of the Hungarian economy. This move directly did not effect Matáv, however the action led to significant depreciation of the forint together with increased volatility, which further enhanced the foreign exchange (EUR/HUF) risk in the market.

The following tables set forth, for the periods and dates indicated, the period-end, average, high and low official rates set by the National Bank of Hungary for Hungarian forint per U.S.\$1.00 and EUR1.00, respectively. The Company makes no representation that the Hungarian forint amounts referred to in this annual report could have been or could be converted into any currency at any particular rate or at all.

<b>Exchange Rates</b> (amounts in HUF/U.S.\$)				
<b>Year</b>	<b>Period-End</b>	<b>Average (1)</b>	<b>High</b>	<b>Low</b>
1999	252.52	237.30	252.63	212.31
2000	284.73	282.27	318.71	245.57
2001	279.03	286.54	304.06	271.35
2002	225.16	258.00	283.98	225.16
2003	207.92	224.44	237.63	206.61
2003				
October	222.70	218.46	222.70	214.01
November	221.12	221.68	227.28	216.50
December	207.92	215.82	227.35	207.92
2004				
January	214.20	209.76	214.37	203.90
February	208.20	207.94	214.48	203.79
March	203.65	206.58	210.76	203.65

(1) The average of the exchange rates on each business day during the relevant period.

**Exchange Rates**  
(amounts in HUF/EUR)

Year	Period-End	Average (1)	High	Low
1999	254.92	252.80	258.86	248.23
2000	264.94	260.04	265.67	254.47
2001	246.33	256.68	267.29	241.45
2002	235.90	242.97	252.38	235.17
2003	262.23	253.51	272.03	234.69
<b>2003</b>				
October	259.13	255.47	259.13	253.41
November	265.03	259.41	265.03	257.05
December	262.23	264.84	272.03	260.70
<b>2004</b>				
January	265.05	264.60	270.00	259.40
February	257.86	262.97	268.47	257.86
March	248.92	253.36	257.21	248.92

(1) The average of the exchange rates on each business day during the relevant period.

The Company will pay any cash dividends in Hungarian forints, and exchange rate fluctuations will affect the U.S. dollar amounts received by holders of American Depository Shares ("ADSs") on conversion of cash dividends on the shares those ADSs represent. Fluctuations in the exchange rate between the Hungarian forint and the U.S. dollar will also affect the prices of shares and ADSs.

## RISK FACTORS

Prior to making any investment decision, you should carefully consider the risks set forth below in addition to the other information contained in this annual report. The risks described below are not the only risks we face. Additional risks not currently known to us or risks that we currently regard as immaterial also could have a material adverse effect on our financial condition or results of operations. This annual report contains certain "forward-looking" statements. These include statements on expectations of Matáv's businesses. You will find below and elsewhere in this annual report important factors that could cause the results of Matáv to differ materially from such forward-looking statements. Matáv disclaims any obligation to update information contained in any forward-looking statement.

### **Matáv's operations are subject to substantial government regulation, which can result in adverse consequences for the Company's business and results of operations.**

The Act XL of 2001 on Communications ("Act on Communications") was approved by the Hungarian Parliament in June 2001 and entered into force on December 23, 2001. This act became the basis for the liberalized telecommunications market in Hungary. The Act on Communications established a new regime of retail price controls on fixed line voice telephony services, introduced a universal service obligation and designated Matáv as a company with significant market power on the voice telephony market. The Act on Communications also required unbundling of local loops, transparency of cost-based pricing, and reference offers for interconnection, and for leased line interconnection services. Service providers with significant market power are obliged by law to prepare reference offers and to have the reference offers approved by the regulator. These reference offers contain all the main terms and conditions (services, prices etc.) which are relevant in an interconnection or unbundling agreement. The cost base of the price of these services had to be calculated using Long Run Incremental Costs ("LRIC") from January 1, 2003. The Act on Communications introduced carrier selection and carrier pre-selection possibilities.

The Act on Communications was not in full conformity with the New European Union ("EU") Regulatory Framework for Telecommunications. In order to achieve harmonization of the telecommunications regulatory regime in Hungary to the EU Regulatory Framework and to further encourage competition, Act C of 2003 on Electronic Communications ("Act on Electronic Communications") was drafted and later approved by the Parliament. The main elements of the new regulation are as follows: Internet regulation, Significant Market Power ("SMP") obligation regulation, carrier selection, costing methodology, number portability regulation and institutional issues. The new act came into force on January 1, 2004.

The Company cannot fully anticipate the combined impact of these changes on its business and results of operations. Matáv's business and results of operations may be adversely affected by the new Hungarian telecommunications regulatory regime.

The liberalization of the fixed line telecommunications market is expected to have an effect on the mobile telecommunications industry as well. On November 4, 2002, the National Regulatory Authority ("NRA", Hírközlési Felügyelet) designated, for the first time, Westel as an SMP in the interconnections market. Westel was obligated to decrease its fixed-to-mobile termination charges by 10 percent, effective September 1, 2003. This status was assigned again to Westel on November 6, 2003, as a result of an annual assessment by the NRA. It is expected that government regulated fees and interconnection prices may change significantly in the future and such changes could adversely impact the operations of Westel.

Under the auspices of the new regulatory regime in Hungary, two changes affecting telecommunications customers' ability to retain telephone numbers when switching a carrier have been

implemented recently. From January 1, 2004, telecommunications customers are entitled to the geographic number portability, or the ability to retain a telephone number associated with a fixed telephone line when switching a carrier. From May 1, 2004, this portability was extended to include telephone numbers associated with mobile phone and non-fixed line.

This change may result in a larger churn rate among both fixed line and mobile customers, thus negatively impacting Matáv's results of operation.

See "Item 4 Regulation and Pricing"

**Matáv is subject to increased competition due to telecommunications sector liberalization.**

Competition in the Hungarian telecommunications sector is increasing as a result of market liberalization measures. Since December 23, 2001, other service providers have had the right to compete directly for Matáv's customers across Hungary in the public telephony services.

As a result of limited success that the Act on Communications had on the Hungarian telecommunications sector, the Act of Electronic Communications came into force on January 1, 2004 to further facilitate competition and encourage new entrants to the market. Although the identities of such new entrants are already known to some degrees, the scope of competition and any adverse effect on the Company's results will depend on a variety of factors that we currently cannot assess with precision and are for the most part not within the Company's control. Among such factors are the business strategies and capabilities of potential competitors, prevailing market conditions, the effect of Hungary's accession to the European Union, as well as the effectiveness of the Company's efforts to prepare for new market conditions, including increased competition, effected by the new regulatory regime.

In the mobile communications business, Matáv already faces intense competition. As all telecommunications markets have become increasingly saturated, the focus of competition is starting to shift from customer acquisition to customer retention. Significant customer defections have an adverse effect on results of operations, and customer acquisition and retention expenses are substantial. Due to the increased level of competition, prices for mobile voice telephony have been declining over the past several years and may continue to decline. Matáv also faces intense competitive pressure in the market for Internet services, as well as in the data communications markets.

Competition in any or all of Matáv's principal lines of business could lead to:

price erosion of Matáv's products and services;

inability to increase market share or loss of market share;

loss of existing or prospective customers and greater difficulty in retaining existing customers;

more rapid deployment of new technologies and obsolescence of existing technologies; and

other developments that could have a material adverse effect on Matáv's financial condition and results of operations.

**Matáv's ability to sustain revenue growth will depend in part on increasing traffic and offering value added and data services to its customers.**

Matáv expects the number of fixed access lines and tariffs for telephony services to decrease as competition in fixed and mobile telephony increases. Matáv's ability to sustain revenue growth will therefore depend on increasing the amount of traffic over existing fixed lines and on increasing revenues from value added and data services. Matáv also plans to sustain revenues by growing its mobile subscriber base and expanding its related lines of business, such as Internet and cable television, as well as by geographic expansion. Matáv may not be able to sustain revenue growth, if it is not able to offer attractive and affordable value added services in the future or if the Company's customers do not purchase its services.

**Matáv may be unable to adapt to technological changes in the telecommunications market.**

The telecommunications industry is characterized by rapidly changing technology with related changes in customer demands and the need for new products and services at competitive prices. Technological developments are also shortening product life cycles and facilitating convergence of different segments of the increasingly global information industry. Matáv's future success will largely depend on its ability to anticipate, invest in and implement new technologies with the levels of service and prices that customers demand. Technological advances may also affect Matáv's level of earnings by shortening the useful life of some of its assets.

The operation of Matáv's businesses depends in part upon the successful deployment of continually evolving mobile communications technologies, which will require significant capital expenditures. There can be no assurance that such technologies will be developed according to anticipated schedules, that they will perform according to expectations, or that they will achieve commercial acceptance. Matáv may be required to make more capital expenditures than are currently expected if suppliers fail to meet anticipated schedules, if a technology's performance falls short of expectations, or if commercial success is not achieved.

The effect of technological changes on Matáv's businesses cannot be predicted. In addition, it is impossible to predict with any certainty whether the technology selected by Matáv will prove to be the most economic, efficient or capable of attracting customer usage. There can be no assurance that Matáv will develop new products and services that will enable Matáv to compete effectively in the Hungarian telecommunications market.

**Developments in the technology and telecommunications sectors have resulted and may result in substantial write-downs of the carrying value of certain of our assets.**

Recent developments in the technology and telecommunications sectors, including significant declines in stock prices, market capitalization and credit ratings of market participants may result in substantial write-downs of our tangible, intangible or other assets. Future changes in these areas could lead to further write-downs at any time. Recognition of impairments of tangible, intangible and financial assets could adversely affect our results of operations and financial condition and might lead to a drop in the trading price of our shares. We review on a regular basis the value of each of our subsidiaries and their assets. The value of goodwill is reviewed annually. In addition to our regular valuations, whenever indications exist (due to changes in the economic, regulatory, business or political environments) that goodwill, intangible assets or fixed assets may be impaired, we consider the necessity of performing certain valuation tests which may result in an impairment charge.

**We depend on a limited number of suppliers for equipment and maintenance services.**

In each of our operating divisions, there are a limited number of suppliers for required equipment and maintenance services. The failure of these suppliers to meet our equipment and service needs in a timely manner might have a significant effect on our revenues and market position. The construction and operation of our networks and the provision of our services and network infrastructure, especially mobile telecommunications services, are dependent on our ability to obtain adequate supplies of a number of items on a timely and cost-efficient basis. These include handsets and transmission, switching and other network equipment. Significant delays in obtaining certain equipment and maintenance services could have a material adverse effect on our business or results from a particular operating division.

**Matáv's business may be adversely affected by actual or perceived health risks associated with mobile communications technologies.**

Media reports have suggested that certain radio frequency emissions from cellular telephones may be linked to certain medical conditions such as cancer. In addition, certain consumer interest groups have requested investigations into claims that digital transmissions from handsets used in connection with digital mobile technologies pose health concerns and cause interference with hearing aids and other medical devices. There can be no assurance that the findings of such studies will not have a material effect on Matáv's mobile business or will not lead to government regulation. Matáv's ability to install new mobile telecommunications base stations and other infrastructure may also be adversely affected, and related costs may increase, due to regulation or consumer action in response to concerns over health risks and the impact on the value of properties adjacent to such infrastructure. The actual or perceived health risks of mobile communications devices could adversely affect mobile communications service providers, including Matáv, through increased barriers to network development, reduced subscriber growth, reduced network usage per subscriber, threat of product liability lawsuits or reduced availability of external financing to the mobile communications industry.

**System failures could result in reduced user traffic and reduced revenue and could harm Matáv's reputation.**

Matáv's technical infrastructure (including its network infrastructure for fixed-network services and mobile telecommunications services) is vulnerable to damage or interruption from information technology failures, power loss, floods, windstorms, fires, intentional wrongdoing and similar events. Unanticipated problems at its facilities, system failures, hardware or software failures or computer viruses could affect the quality of Matáv's services and cause service interruptions. Any of these occurrences could result in reduced user traffic and reduced revenue and could harm Matáv's reputation.

**Matáv's credit rating may be linked to the credit rating of its parent company, Deutsche Telekom.**

Matáv's credit rating was lowered by Standard & Poor's Ratings Services ("S&P") to BBB+ in April 2002, because of the downgrade of credit rating of its parent company, Deutsche Telekom ("DT"). Moody's Investors Services ("Moody's"), however, maintained its credit rating of Matáv at Baa1, while lowering DT's rating to Baa3 in January 2003.

Both agencies downgraded DT's credit ratings as a result of the substantial increase in DT's outstanding debt that was incurred to finance acquisitions and investments. Deutsche Telekom has strived to reduce its outstanding debt since then and, as a result, its financial position has significantly improved.

Its rating was affirmed by S&P in July 2003 and has a stable outlook, while currently it is on credit watch by Moody's for a possible upgrade. However, we cannot guarantee that DT's credit rating will improve in the future or will not be downgraded further.

S&P sees Matáv as a strategic investment of DT; therefore, it is very likely that S&P rating of Matáv will closely trail that of DT in the future as well. As the interest rates on Matáv's existing indebtedness are not linked to its credit rating, downgrading of Matáv's credit rating will not increase its financial obligations under the existing indebtedness. However, such downgrade may increase the cost of borrowing in the future and may adversely affect Matáv's financial position and results of operation.

**Loss of key personnel could weaken Matáv's business expertise.**

Matáv's operations are managed by a small number of directors and key executive officers. The loss of directors or key executive officers could significantly impede Matáv's financial plans, marketing and other objectives. Matáv believes that the growth and future success of its business will depend in large part on its continued ability to attract and retain highly skilled and qualified personnel at all levels; however, the competition for qualified personnel in the telecommunications industry is intense. Matáv can give no assurances that it will be able to hire or retain necessary personnel.

**Matáv's share price may be volatile, and your ability to sell Matáv shares may be adversely affected due to the relatively illiquid market for Matáv securities.**

The Hungarian equity market is relatively small and illiquid compared to major global markets. As a result of the limitations of the Hungarian equities market and the volatility of the telecommunications sector, the price of Matáv shares may be relatively volatile and you may have difficulty selling your shares in the event of unfavorable market conditions.

**Matáv has a substantial business interest based in Macedonia, where ethnic hostilities and economic pressures could reduce the value of Matáv's investment in that region.**

Matáv owns 89.51 percent interest in Stonebridge Communications AD ("Stonebridge"), which owns 51 percent interest in MakTel, the formerly state-owned public telecommunications service provider in Macedonia. MakTel became a consolidated subsidiary of Matáv beginning on January 15, 2001.

Ethnic hostilities, while getting better, continue to pose significant risk to the economy of Macedonia. The negative pressure on the economy could lead to a devaluation of the currency. In case of a devaluation of the Macedonian denar, the value of Matáv's interest in MakTel would be reduced and Matáv's financial condition and results of operation may be adversely affected.

**MakTel may lose its dominant position and face significant competition as a result of the market liberalization measures in Macedonia.**

The series of market liberalization measures in the telecommunications sector is planned to take place in Macedonia starting in 2005. MakTel is currently the only provider of fixed line telecommunications services that is allowed to operate in Macedonia. As a result of the market liberalization measures, however, MakTel's exclusive rights to provide fixed line telecommunications services will expire in December 2004 and other firms may start to provide services that are currently offered by MakTel.

Competition posed by such new entrants may result in downward pressure on MakTel's pricing, sales volume and profitability, which would have an adverse effect on our results of operations and financial condition.

**The value of our investments, the results of our operations and our financial condition could be affected by economic developments in Hungary and other countries.**

Our business depends on general economic conditions in Hungary and abroad. From 2001 to 2003, there was a downturn in global economy in general and in the telecommunications industry in particular. There are many factors that influence global and regional economies, which are outside of our control. A cautious or negative business outlook may cause our customers to delay or cancel investment in information technology and telecommunications systems and services, which would adversely affect Matáv's revenues directly and, in turn, slow the development of new services and applications that could become future revenue sources. In addition, Hungary's accession to the European Union may impact the economic conditions in Hungary. If the global and regional economies do not improve, we may continue to experience adverse effects on our business, operating results and financial condition.

**Fluctuations in currency exchange rate could have an adverse effect on our results of operations.**

Matáv is subject to currency translation risks, mainly relating to the results of its Macedonian operations. A devaluation of the Macedonian denar and a strengthening of the Hungarian forint may exert a negative influence on MakTel's results that are converted into HUF, thereby lowering Matáv's results. This is mainly a reporting risk, but through the dividend payments it has direct financial (cash-flow) effects on Matáv as well.

**Matáv is subject to risks resulting from fluctuations in interest rates.**

Matáv is subject to risks resulting from fluctuations of interest rates, which can affect costs associated with Matáv's interest bearing obligations and certain other payments. Matáv's debt portfolio consists of approximately equal amount of floating rate and fixed rate obligations. The floating rate loans decrease the predictability of Matáv's financing costs since interest is always paid according to the current market interest rates. Fixed rate loans also bear risks of fluctuating interest rates as Matáv may have to pay interest at a higher rate on fixed rate loans than the prevailing market interest rate, and Matáv may not be able to refinance itself at a lower interest rate.

In 2002 and 2003, Matáv refinanced its indebtedness denominated in euro and replaced them with indebtedness in Hungarian forint. As the interest rate volatility associated with the Hungarian forint is much higher than that associated with euro, the Company may be exposed to higher interest rate volatility. In order to mitigate such volatility, Matáv's debt portfolio was modified to include approximately equal amount of fixed rate and floating rate indebtedness. However, Matáv cannot guarantee that such strategy will sufficiently decrease its exposure to interest rate volatility. Such volatility may lead to unexpected increase in interest payment obligations, which would adversely affect the Company's financial positions and results of operation.



## ITEM 4 INFORMATION ON THE COMPANY

### ORGANIZATION

The legal name of the Company is Magyar Távközlési Rt. and it operates under its commercial name, Matáv. Matáv is a stock corporation operating under the laws of Hungary. The Company is the principal provider of fixed line telecommunications services in Hungary. Its shares are listed on the Budapest Stock Exchange, and its ADSs are listed on the New York Stock Exchange. Matáv's headquarters are located at 55 Krisztina krt., 1013 Budapest, Hungary. Its telephone numbers are 36-1-458-0000 or 36-1-458-7000. Its U.S. agent for federal securities law purposes is CT Corporation, 111 Eight Avenue, New York, New York 10011, USA.

### HISTORICAL BACKGROUND

Prior to 1990, the Hungarian national postal, telephone and telegraph authority, Magyar Posta, provided all public telephony services in Hungary. As of January 1, 1990, the Hungarian Government split Magyar Posta into three distinct entities along the lines of its three main areas of operation: postal services, telecommunications and broadcasting. The Hungarian Government made Magyar Távközlési Vállalat, the predecessor entity to Matáv, responsible for telecommunications operations. This entity was transformed on December 31, 1991 into a stock corporation, Magyar Távközlési Rt., or Matáv, then wholly owned by the predecessor of the Állami Privatizációs és Vagyonkezelő Rt. (the "State Privatization and Holding Company" or the "ÁPV").

MagyarCom GmbH ("MagyarCom"), a holding company in which Deutsche Telekom and Ameritech Corporation ("Ameritech") each held a 50 percent interest, was selected by the Minister in an international tender and subsequently purchased a 30.1 percent stake in Matáv for approximately U.S. dollar 875 million on December 22, 1993. The ÁPV contributed U.S. dollar 400 million of the purchase price paid by MagyarCom to Matáv to provide it with capital to expand the telephone network.

MagyarCom entered into a concession agreement with the Hungarian Government on December 19, 1993. MagyarCom then assigned certain of its rights under the concession agreement to Matáv. On December 22, 1993, Matáv entered into a concession contract (the "Concession Contract") with the Hungarian Government, which gave Matáv the exclusive right to provide domestic long distance and international public telephony services throughout Hungary and local public fixed line voice telephony services in 31 of 54 Local Primary Areas for a term of eight years ending December 22, 2001. On May 24, 1994, Matáv obtained the right to provide telephony services in an additional five Local Primary Areas for a term of eight years ending May 25, 2002.

On December 22, 1995, MagyarCom acquired from the ÁPV an additional 37.2 percent interest for approximately U.S. dollar 852 million, raising its stake to 67.3 percent.

In connection with the Company's initial public offering in November 1997, both MagyarCom and the ÁPV collectively sold 272,861,367 shares or 26.31 percent of then outstanding shares. In June 1999, the ÁPV sold its remaining 5.75 percent stake in Matáv in a secondary offering.

On October 8, 1999, SBC Communications Inc. ("SBC") completed its acquisition of Ameritech and thus gained control over Ameritech's 50 percent interest in MagyarCom.

On July 3, 2000, SBC sold its 50 percent ownership in MagyarCom to Deutsche Telekom, making Deutsche Telekom a 100 percent owner of MagyarCom.

As of December 31, 2003, 59.21 percent of Matáv's ordinary shares was held by MagyarCom, 40.32 percent of the ordinary shares was publicly traded and the Company had 0.47 percent treasury shares. The Hungarian Government controls one Series "B" voting preference share to which special rights attach.

On October 21, 1999, Matáv announced that it had entered into an agreement with DT providing Matáv the option to acquire DT's 49 percent interest in Westel and Westel 0660 for a price of U.S. dollar 885 million. On December 21, 2001 Matáv paid DT EUR 920 million (HUF 227 billion) and had agreed to pay in 2002 an additional amount equal to 49 percent of the dividend to be declared by Westel for 2001. Based on the amount of dividend with respect to 2001 declared by Westel, Matáv had to pay an additional HUF 11.5 billion.

In December 2000, the Company, on behalf of a consortium, reached agreement with the government of Macedonia to purchase 51 percent of MakTel on its privatization. The closing of the transaction took place on January 15, 2001, whereby the Company paid EUR 343.3 million on behalf of the consortium in accordance with the relevant agreement. The 51 percent ownership acquired by Matáv was contributed on January 16, 2001 to a newly established Macedonian acquisition vehicle, Stonebridge.

In accordance with a subscription and shareholders' deed ("Deed") between Matáv, SEEF Holdings Ltd. ("SEEF") and CosmoTelco Added Value Services S.A. ("CosmoTelco"), the latter two acquired a 6.1 percent and a 7.4 percent ownership respectively in Stonebridge reducing Matáv's investment in Stonebridge to EUR 301.5 million. Matáv, consequently, had an 86.5 percent stake in Stonebridge, which owns 51 percent of MakTel, thereby Matáv had an effective ownership percent in MakTel of approximately 44 percent.

The Deed provides for a put option which entitles SEEF to sell its shares to Matáv on May 15 of each of 2003, 2004 or 2005 or upon the occurrence of certain events at a price formula also set out in the Deed. The formula takes into account the purchase price paid by the consortium for the shares, Earnings Before Net Interest and Other Charges, Tax, Depreciation and Amortization ("EBITDA") and the net debt of MakTel.

Pursuant to the terms of the Deed, SEEF exercised its put option relating to its 3.05 percent holding in Stonebridge on June 20, 2003 and Matáv paid EUR 21 million to SEEF on July 27, 2003. Following the closing of the transaction, Matáv had an 89.51 percent ownership in Stonebridge with an effective ownership share in MakTel of 45.65 percent.

See "Item 10 Material contracts".

## DESCRIPTION OF BUSINESS AND ITS SEGMENTS

Matáv is the principal provider of fixed line telecommunications services in Hungary, with approximately 2.8 million fixed access lines at December 31, 2003. The Company is also Hungary's largest mobile telecommunications service provider, with more than 3,766,000 mobile subscribers (including users of prepaid cards) at December 31, 2003. The Company's total consolidated revenues were HUF 607,252 million, and its total consolidated net income was HUF 57,475 million in 2003.

Matáv is a full-service telecommunications provider operating in three business segments:

*Fixed Line Telecommunications Services.* The Company's fixed line telecommunications services consist of local, long distance, international and other telecommunications services, including data transmission, cable television and Internet services. The Company had exclusive rights through December 2001 to provide domestic long distance and international public telephony services throughout

Hungary and to provide local public fixed line telephony service in 31 of the 54 local primary areas in Hungary. The Company had exclusive rights in five of the 54 local primary areas until May 2002, while its subsidiary, Emitel had exclusive rights in an additional three concession areas through November 2002. The Company's 36 former local concession areas cover approximately 70 percent of Hungary's geographic area and include Budapest as well as nearly all of the other major cities in Hungary. As there is limited competition for public voice telephony services even after the liberalization of the telecommunications market, Matáv is still the dominant service provider in these 36 areas. Matáv also provides leased lines, data transmission services and corporate network services, sells telecommunications equipment and offers network construction and maintenance services. Matáv is the market leader in Hungary for most of these services.

*Mobile Telecommunications Services.* Through its mobile telecommunications subsidiary, Westel, the Company is a leading provider of mobile telecommunications services in Hungary. Westel is one of three GSM digital providers in Hungary. Matáv's former mobile subsidiary, Westel 0660, merged into Westel on November 30, 2003. Mobile telecommunications services have contributed significantly to the Company's revenue growth. Revenues from mobile telecommunications services increased from HUF 198,947 million before intersegment eliminations in 2001 to HUF 254,141 million before intersegment eliminations in 2003, while the number of subscribers increased to approximately 3.8 million by the end of 2003 from 1.7 million at the end of 2000.

*International Activities.* The international segment includes four Macedonian companies. Stonebridge is a holding company through which Matáv controls MakTel. MakTel is Macedonia's exclusive fixed line telecommunications company. Its exclusive rights in fixed line telecommunications services will expire in December 2004. These exclusive rights include local, national and international long distance public voice services, voice over Internet Protocol ("IP") services, leased lines services and the construction and operation of public voice network services. MobiMak is MakTel's subsidiary, which is the leading mobile telecommunications service provider in Macedonia. Telemacedonia is a management company through which Matáv provides management and consulting services to MakTel, MobiMak and Stonebridge. Matáv's acquisition of MakTel closed on January 15, 2001 and MakTel became a consolidated subsidiary as of that date. This transaction has contributed significantly to the Company's revenue growth. Revenues from international activities were HUF 70,014 million before intersegment eliminations in 2003.

## STRATEGY

### *The Hungarian telecommunications market and Matáv's current position*

Matáv has a leading position in the integrated telecommunications service sector in Hungary. Despite the liberalization of the Hungarian telecommunications market at the end of 2001, Matáv has successfully retained its leading position in all market segments. Accordingly, we believe that Matáv is positioned well to play a leadership role and continue its course of sustainable growth.

Since 1999, the Hungarian telecommunications market grew by an annual rate of 11 percent according to Matáv estimates. Most of the growth was due to growth in mobile telecommunications market. Hungarian mobile penetration rate has already reached the average Western European levels. However, the pace of growth is expected to slow after penetration rate exceeds 80 percent. Additionally, data and Internet services are emerging as promising growth drivers, in line with management's expectation and focus on these sectors. For example, broadband penetration rate almost tripled in 2003 as a result of Matáv's intensive Asymmetrical Digital Subscriber Line ("ADSL") marketing campaign.

Competition continues to develop in both the fixed line and mobile markets. In fixed line, competitors have gained momentum only in certain segments (mainly corporate) so far. In mobile, rapid growth of the Hungarian market has attracted competitors with strong global background such as Vodafone.

*Matáv's future operational environment*

*Regulatory environment*

The first key trend, which will determine Matáv's future operational environment, is the development of the regulatory regime in line with the requirements of the European Union. Matáv has successfully avoided the "worst case" regulatory scenario by implementing proactive regulatory management, however several adverse regulatory changes are planned for 2004, which may disadvantage established service providers such as Matáv. Regulatory management must remain an area of intense focus for management to ensure the best possible operating conditions.

*Fixed/mobile substitution*

The second major trend is fixed-mobile substitution. The key competitors of the fixed line business are the mobile service providers. In the long run, the outcome of the current fixed-mobile substitution process will play the most important role in shaping the voice and data markets. Accordingly, defense of the fixed line business that at the same time complements Matáv's growth objective for Westel's mobile business will be the second key area of management focus for the coming year. Key elements of the fixed line defense strategy include making the existing fixed line service more attractive (e.g. consumer friendly pricing plans such as a flat-rate plan for unlimited long-distance calls, extended broadband services) and offering "one-stop" solutions for the customers' all telecommunications needs.

*Matáv's strategic approach to creating maximum value*

Matáv's management is committed to a comprehensive value creation program that includes pursuit of all organic and non-organic growth opportunities.

The following four areas are the key elements of this program:

**1. Maximize the value of the residential voice market**

*Residential Mobile Business: consolidate market leadership*

Strengthening Westel's position in the residential mobile market is important given the mobile telecommunications' increasing role in the telecommunications market. To achieve this goal, management has adopted four strategic goals:

Guard our profitability while stabilizing our market share;

Be a market leader through introduction of innovative products and focus on product and service quality;

Strengthening the "value for money" message, promising the customers a full-spectrum of high-quality services at affordable and competitive prices;

Introduce tailored promotions for high and middle value segment and extend the existing retention programs.

*Residential Fixed Line Business: defend access base*

Matáv's management will take all possible actions to increase the value of the fixed line residential voice business. Two strategic guidelines address this issue:

Extend churn management initiatives (e.g. customer relations management, proactively contacting customers intending to switch to another provider, service level differentiation, boosting Internet access); and

Gradually introduce flat-rate voice pricing plans to increase competitiveness of the fixed line business. The flat-rate pricing plan has the potential to dramatically increase the value of the fixed line subscription to the customer.

*Mobile and Fixed Residential Lines Business: offer integrated fixed-mobile propositions*

In addition, Matáv plans to evaluate the feasibility of integrated fixed-mobile service plans for residential customers.

**2. Strengthen Matáv's leadership in the corporate sector**

*Corporate Telecommunications Business: increase competitiveness and develop system integration business*

The corporate telecommunications market in Hungary continues to grow, as demand for business data services increases. Due to intense competition in the market, the primary strategic initiative in the corporate sector remains to continue to improve competitiveness:

Improve our sales force through further training, rigorous staff selection, performance management and incentives;

Use bundled service contracts to strengthen relationships with key accounts while avoiding direct price competition; and

Improve sector focus using reorganized account management/sales force structure.

Successful initiatives to market "solutions" to corporate customers have been in process for a year; Matáv will continue to expand in this area. The "Partnership Program" presents an opportunity to capture a share of system integration revenues by cooperating with system integrator partners.

*Corporate Fixed Line, Mobile and Internet Business: offer bundled value propositions*

Matáv is exploring introduction of business value plans that include products and services from its fixed line, mobile and Internet businesses to leverage the Company's status as the only integrated telecommunications service provider in the market. Customers have demonstrated demand for such services and Matáv can offer greater value in some cases by approaching customers as a group rather than as separate business units. Management is testing the feasibility of fully bundled value plans by evaluating market demand and creating a set of integrated product offers and joint bidding processes to test in the market.

### 3. Develop new growth areas

*Residential and Internet Business: grow ADSL and dial-up profitability*

The Internet market is Matáv's important growth area, both because of its intrinsic profit potential and its importance in retaining fixed line access subscriptions. Management has adopted a number of measures to continue ADSL growth while restoring rapid growth to the dial-up market:

Pursue aggressive growth plans in ADSL following the successful ADSL growth campaign in 2003;

Restore growth in the dial-up market through "breakout" ideas, such as aggressively promoting "Open Internet" (Internet access for a per-minute fee without any monthly fee, call set up charge or registration fee), offering a simplified and competitive dial-up product package, and supporting content development; and

Coordinate between Matáv's Internet brands to create effective product migration paths, coordinate marketing communication and promotions, and avoid competition within the Group.

### 4. Reduce costs

*Continue to identify and exploit further cost reduction opportunities*

Cost reduction may represent Matáv's most important short-term value creation opportunity in light of saturating/stagnating markets. Financial cost reduction measures have been successfully used at Matáv for several years. Management is, however, committed to significant cost reduction over the next three years to further enhance efficiency. Several cost areas are being carefully studied to ensure that all cost reduction opportunities are identified and exploited.

### International segment - MakTel Group

Macedonia's telecommunications market is growing and is expected to outpace the GDP growth over the next three years. With a relatively low penetration rate and the entry of a second service provider, the mobile market is now entering its rapid growth phase and mobile penetration rate is expected to increase dramatically over the coming years. Internet is also expected to enter into a phase of rapid growth in Macedonia.

In the long term, Matáv's objective is to make MakTel the most successful telecommunications company in the Balkans. In order to secure sustainable profitability and strong financial performance, management has developed a Value Creation Program with the aim to increase MakTel's value by pursuing all feasible revenue growth and cost reduction opportunities. The program consists of five major categories, as follows:

*Improve fixed line residential business:* introduce new pricing plans to improve average revenue per user ("ARPU") and support soft rebalancing; realign sales force structure and increase sales where capacity exists; improve receivables management;

*Enhance MakTel's corporate position:* strengthen key account management and introduce focus to improve sales; upgrade value plans for major corporate clients;

*Maintain mobile leadership:* harmonize mobile and fixed line operations to preserve dominant market position; apply appropriate pricing for both prepaid and regular accounts to ensure rapid customer base growth while successfully defending dominant market position;

*Redesign the Internet business model:* act as a market shaper to increase dial-up penetration; launch ADSL broadband services; and

*Optimize MakTel's cost structure:* bring operating costs and capital expenditure down to minimum sustainable levels.



**OVERVIEW OF MATÁV'S REVENUES AND PRINCIPAL ACTIVITIES BY BUSINESS SEGMENTS**

For the years ended December 31, 2001, 2002 and 2003, Matáv's total revenues by business segments were as follows:

	Year ended December 31,			Year ended December 31,
	2001	2002	2003	2003/2002
	(in HUF millions)			(% change)
<b>Fixed line telecommunications services segment</b>				
Subscriptions, connections and other charges	97,942	98,797	98,250	(0.6)
Domestic traffic revenues	123,366	118,839	112,227	(5.6)
Other usage	24,276	20,885	15,365	(26.4)
International traffic revenues	32,339	27,274	22,513	(17.5)
Leased lines	18,010	20,377	21,286	4.5
Data transmission and related services	15,184	17,597	22,550	28.1
Telecommunications equipment sales	3,582	3,671	2,949	(19.7)
Other revenues	18,986	28,866	29,412	1.9
	<b>333,685</b>	<b>336,306</b>	<b>324,552</b>	<b>(3.5)</b>
<b>Mobile telecommunications services segment</b>				
International segment	60,034	67,562	70,014	3.6
Intersegment eliminations	(44,931)	(45,895)	(41,455)	(9.7)
	<b>198,947</b>	<b>232,612</b>	<b>254,141</b>	<b>9.3</b>
<b>Total</b>	<b>547,735</b>	<b>590,585</b>	<b>607,252</b>	<b>2.8</b>

Most of Matáv's revenues in 2001, 2002 and 2003 were derived from services provided within Hungary, except for the revenues of the international segment, which were mainly derived from services provided within Macedonia.

The business of Matáv is not materially affected by seasonal variations.

**Fixed Line Telecommunications Services Segment**

In 2003, Matáv's fixed line telecommunications services generated revenues of HUF 324,552 million before intersegment eliminations. Fixed line telecommunications services consist of domestic and international services, leased lines, data transmission, cable television and Internet services, telecommunications equipment sales, construction, maintenance and other services.

**Domestic Services**

Domestic fixed line voice telephony, Matáv's principal business activity, generated revenues of HUF 225,842 million in 2003, HUF 238,521 million in 2002 and HUF 245,584 million in 2001, in each case before intersegment eliminations.

Revenues from domestic fixed line voice telephony consist of:

subscriptions, connections and other charges;

domestic traffic revenues; and

other usage.





*Products and Services*

*Local and Long Distance Calling Services.* Matáv provides local, domestic and international long distance telephony service to its fixed line telephony subscribers.

*Digifon Services.* The improved level of digitalization of its exchanges permits the Company to offer value added digifon services, such as call forwarding and call waiting, to a significant number of its fixed line telephony subscribers. These services contribute to increased fixed line usage by avoiding busy signals or unanswered calls.

*Shared Cost/Toll Free Numbers.* To enable business customers to better meet the needs of their clients, Matáv has introduced a wide range of "blue" numbers, which are shared cost numbers, and "green" numbers, through which businesses provide toll free access for their customers.

*Voice-mail.* In November 1999, Matáv launched a voice-mail product. Matáv believes voice-mail is an attractive service for subscribers while it simultaneously increases the number of completed calls. In August 2000, Matáv enriched the service by introducing call return and call capture functions as part of the basic voice-mail service. In July 2001, Matáv introduced voice-mail Short Message Service ("SMS"), which provides an SMS alert to the mobile handset of the customer each time he or she receives a voice-mail message. These services allow better usage of the network, more comfort in using the phone and decrease the ratio of uncompleted calls. As of December 31, 2003, voice-mail subscribers amounted to approximately 400,000.

*Fixed SMS.* In September 2002, Matáv launched a new messaging service called Fixed SMS. The service first operated within Matáv Rt.'s network and between Matáv Rt.'s and Westel's networks. From February 1, 2003 this service is also available between Matáv Rt.'s and Pannon GMS Rt's ("Pannon's") networks. From the fixed line, short text messages can be sent with an SMS-capable phoneset and SMS termination is available for every subscriber. If the SMS's addressee does not have an SMS-capable phoneset, the text message is sent as a voice message (text-to-speech function). The maximum length of an SMS is 160 characters. The service has other useful functions as well: SMS to fixed fax machines, SMS redirection and multi-SMS sending.

*Integrated Services Digital Network ("ISDN").* ISDN allows a single access line to be used simultaneously for a number of purposes, including voice, data, facsimile and video transmission. ISDN also provides higher quality connections with faster transmission of signals while increasing the bandwidth capacity of the network. The coverage of ISDN is 95 percent of Matáv Rt.'s network. Matáv offers both basic ISDN access lines with two channels and multiplex ISDN access lines with 30 channels. As of December 31, 2003, Matáv had installed 185,459 ISDN access lines with two channels and 5,227 ISDN access lines with 30 channels, amounting to 527,728 total ISDN channels compared to 305,882 channels at the end of 2000. In 2003, Matáv introduced the Turbo ISDN service. This product provides the highest speed dial-up Internet connection (128 Kbit/s). The Turbo ISDN service extended the life-cycle of the mature ISDN product without any additional investment.

*Private Branch Exchange ("PBX") Services.* Matáv offers PBX services through one of its subsidiaries, Matávcom Kft. As of December 31, 2003, Matávcom Kft. leased and sold approximately 35,000 ports. The vast majority of the equipment leased is digital and meets the demands of developing technologies such as ISDN and digital enhanced cordless telecommunications.

*Calling Cards.* In 2003, the Hazaszámlázó Calling Card was introduced for residential customers choosing the Csevegő and Felező pricing plans. The subscribers of the Sokatmondó pricing plan can purchase the Sokatmondó Calling Card, while the business customers subscribing for the Ritmus pricing plan can also purchase Ritmus Calling Cards. These calling cards allow customers to enjoy the discounts provided by their fixed line pricing plans when using their cards from public payphones in Hungary or abroad.

*Directory Assistance.* The Company offers directory inquiry services. The high-quality directory assistance service received 31.2 million inquiries relating to domestic and 0.5 million inquiries relating to foreign phone numbers in 2003. The domestic directory assistance database includes all fixed line and non-prepaid mobile subscribers' data in Hungary. We offer a call completion option to Matáv Rt. and Westel subscribers, whereby calls may be connected automatically. Matáv's directory services center performed 6.3 million call completions in 2003. The Directory Assistance-Plus ("DA-Plus") service is becoming increasingly successful. DA-Plus offers a wide range of information including Yellow Pages, residential classified advertisements, encyclopaedia, dictionary-based information, recipes, poems, as well as telephone numbers, postal, e-mail and website addresses without any quantity restrictions. The tariff of the service is based on per minute usage. The number of minutes charged by the DA-Plus service was 5.7 million in 2003.

#### *Subscribers*

The following table sets forth information regarding total fixed access lines and penetration rates in Matáv's service areas:

	<b>At December 31,</b>		
	<b>2001</b>	<b>2002</b>	<b>2003</b>
<b>Lines in service in Matáv Rt.'s service areas:</b>			
Residential lines	2,151,346	2,055,338	2,012,672
Business lines	299,267	282,406	261,642
Public payphones	37,432	33,316	28,799
<b>Total</b>	<b>2,488,045</b>	<b>2,371,060</b>	<b>2,303,113</b>
ISDN channels	448,396	511,326	527,728
<b>Total</b>	<b>2,936,441</b>	<b>2,882,386</b>	<b>2,830,841</b>
Lines in service in Emitel's service areas:	80,899	79,460	78,638
<b>Lines installed per 100 inhabitants:</b>			
in Matáv Rt.'s service areas	39.1	38.4	37.7
Digital exchange capacity as % of Matáv Rt.'s total exchange capacity	85.4	87.1	89.9

Matáv's domestic fixed line telephony subscribers are primarily in two categories: residential customers and business customers. Matáv includes the government among its business customers. As of December 31, 2003, 75 percent of Matáv's access lines were connected to residential customers and 24 percent to business customers. The remaining one percent of access lines was connected to public payphones. Matáv's top 400 customers account for less than 15 percent of the Company's revenues.

The Hungarian government, through its various institutions and departments, constitutes Matáv's largest customer group. Matáv develops separate service packages for each of these institutions and departments, as each of these institutions and departments generally has its own annual budget, particular telecommunications needs and responsibility. From a strategic perspective, however, Matáv considers the Hungarian government to be a single customer. Matáv offers most of its largest customers, including the government, discounts for the services it provides. Matáv estimates that revenues from the Hungarian government in the aggregate accounted for less than five percent of its total revenues in 2003.

*Traffic*

The following table sets forth the total minutes of domestic telephony traffic that Matáv's fixed line subscribers generated, including calls from the fixed line network to mobile subscribers:

	Year ended December 31,		
	2001	2002	2003
	(thousands of minutes)		
Domestic traffic at Matáv Rt.	10,088,137	8,820,201	7,958,292
Domestic traffic at Emitel (1)	91,567	179,670	152,614

(1) Traffic generated since July 1, 2001, the date when Emitel became a fully consolidated subsidiary of the Company.

*Tariffs*

Matáv charges fixed line subscribers a one-time connection fee, monthly subscription charges and traffic charges based on usage. A call charge consists of two elements: a call set-up charge and a traffic charge measured in seconds based on the call's duration. Matáv's tariffs for its fixed line voice telephony services are regulated by the Minister. Matáv may, however, offer services at prices lower than those established by the Minister.

The following table sets forth Matáv Rt.'s domestic fixed line tariffs in each of the years indicated in nominal Hungarian forint. In 2000 and 2001, tariff changes were effective from February 1 for analog lines and from January 1 for ISDN lines. In 2002, monthly subscription fees for analog and ISDN lines changed from February 1. From September 1, 2002 subscription fees for analog lines changed again and local and long distance tariffs have been altered as well. From February 1, 2003, subscription fees for analog and

ISDN lines changed, and local tariffs have been altered as well. In September and October 2003, Matáv reduced the fixed to mobile tariffs.

	As of			
	December 31, 2001	December 31, 2002	December 31, 2003	January 1, 2004
	(HUF, exclusive of VAT) (1)			
<b>Connection fee:</b>				
Residential	27,000	27,000	27,000	27,000
Business	60,000	60,000	60,000	60,000
<b>Standard monthly subscription charge:</b>				
Residential	2,308	2,464	2,568	2,568
Business	3,100	3,320	3,424	3,500
<b>ISDN connection fee:</b>				
Basic	60,000	60,000	60,000	39,000
Multiplex	990,000	990,000	990,000	990,000
<b>ISDN standard monthly subscription charge:</b>				
Basic	3,900-6,900	4,080-7,600	4,080-8,240	4,080-8,570
Multiplex	57,600-75,500	65,000-85,000	68,500-89,600	71,240-93,184
<b>Charge for a three minute peak rate call: (2)</b>				
Local	25.4	27.2	28.4	29.8
From the fixed line network to mobile subscribers (2)	183.8-192.8	183.4-192.4	169.2-186.2	169.2-186.2
<b>Domestic long distance: (2)</b>				
Zone 1 (Extended local)	25.4	27.2	28.4	29.8
Zone 2 (Budapest metropolitan area)	48.8	48.4	57.2	57.2
Zone 3 (Long distance)	75.8	75.4	75.2	75.2

(1) Reflects listed tariffs. From time to time, the Company may offer promotions and discounts from these listed tariffs.

(2) Includes a call set-up charge (HUF 3.8 in 2001, HUF 3.4 in 2002, HUF 3.2 in 2003 and HUF 3.2 in 2004).

Matáv's one-time connection fee and monthly subscription charge are different for residential and business customers. The Company does not charge its business and residential customers different traffic tariffs. Matáv charges the same tariffs on analog telephone lines and on ISDN lines.

The prices above reflect the tariffs for Matáv's Bázis pricing plan. In 2003, Matáv increased the number of pricing plans to allow customers in different market segments to choose pricing plans that best suit their calling patterns. These pricing plans also served as a tool to protect Matáv's customer base in the fully liberalized market as those customers who select Matáv as the operator for every traffic direction (local, long distance and international) receive the highest discounts.

Matáv offers the following primary pricing plans:

*Minimál pricing plan.* This pricing plan was targeted for residential customers with analog lines who use their phones less often but want to be available for incoming calls and would like to pay lower monthly fees. Customers using this pricing plan paid a significantly discounted monthly subscription fee and were allowed a 66.7 percent discount on call set-up fees and call charges to fixed line numbers. The discount could not exceed HUF 500 per month, above which customers had to pay three times the Bázis pricing



plan rates. At the same time, the customers using the Minimál pricing plan had the option to select a favorite friend or relative's fixed line number in Hungary to call at a low, Basic rate throughout a month. By the end of 2003, over 505,000 customers chose this pricing plan. As a result of change in the regulatory environment, Matáv terminated the sales of the Minimál pricing plan from January 1, 2004. Customers who subscribed for this pricing plan as of December 31, 2003 may maintain their Minimál subscription, however, Matáv does not offer it to new customers since January 1, 2004. Consequently, for low-usage residential customers Matáv's best product offering is the Felező pricing plan.

*Felező pricing plan.* On February 1, 2003 Matáv launched Felező pricing plan. With the Felező pricing plan half the monthly fee is applied toward call charges and subscribers can initiate calls without the call set up fee. Calculation of the telephony costs is also easy since the local and the domestic long distance numbers can be called at the same per minute fee. The international, fixed to mobile and Internet per minute fees of the pricing plan are the same as those of the Bázis pricing plan. The discount, that can be used to initiate calls against the monthly fee, cannot be used to generate Internet usage. As of December 31, 2003, over 297,000 subscribers are enrolled in this pricing plan.

*Csevegő pricing plan.* On December 27, 2001, Matáv launched the first pricing plan for residential customers that offers increasing discount for longer calls. The discount is 20 percent from the 5th minute and 30 percent from the 10th minute up to the 60th minute of the call. The discount is valid for all calls all day. From June 16, 2003, half of the monthly fee can be applied toward Internet usage if customers access the Internet via Matáv's Open Internet service. The pricing plan also contains 20 free fixed SMSs per month. In 2003, it was the second most popular pricing plan with approximately 375,000 customers as of December 31, 2003.

*Kontroll pricing plan.* Matáv's first pricing plan involving neither monthly subscription nor call set-up fees for residential customers with analog lines is the Kontroll pricing plan. Subscribers may chose a 30-day card for HUF 3,700, a 60-day card for HUF 7,400, a 90-day card for HUF 10,500, or a 180-day card for HUF 19,500. The card can be refilled during its period of validity or within 10 days after expiry. This pricing plan is similar to mobile prepaid offers.

*Sokatmondó pricing plan.* Matáv launched this pricing plan on October 1, 2002. As of December 31, 2003 over 50,000 customers had ordered this pricing plan. Signing a definite-period pre-selection contract is a precondition for this offer. The elements of the pricing plan are as follows:

Peak period lasts until 3 p.m. in Matáv, i.e. non-Local Telecommunications Operator ("LTO") or non-mobile directions; and until 6 p.m. in LTO and mobile directions;

30 SMSs free of charge per month (in Matáv, Westel and Pannon directions);

60 minutes free Internet access (in cooperation with Axelero); and

Sokatmondó Digifon pricing plan (with caller identification function).

The subscribers of the Sokatmondó pricing plan can order the Sokatmondó calling card, by which calls can be originated at the per minute rates of the pricing plan from Matáv's area and from abroad.

*Ritmus pricing plan.* Matáv offers the Ritmus pricing plan for residential and business customers making calls mainly in peak hours. The pricing plan is available for customers with analog or ISDN lines. Signing a definite-period pre-selection contract is a precondition for this offer. By subscribing to this pricing plan the customers receive discounted per minute rates. Various schemes in the Ritmus pricing plan family:

Ritmus Standard pricing plan: for those customers who mainly make peak-time calls;

Ritmus Helyi (Local) pricing plan: for those customers who mostly make local peak-time calls;

Ritmus Belföldi (Domestic) pricing plan: for those customers who mainly make domestic long distance and international peak-time calls;

Ritmus Mobile pricing plan: for those customers who mainly make mobile and international peak time calls;

Ritmus Csúcs (Peak) pricing plan: for those high-end customers who wish to take advantage of heavily discounted rates to every call direction;

Ritmus Calling Card, which is available with any of the Ritmus pricing plans free of charge to use the rates of the Ritmus pricing plan family from any Matáv telephone in Hungary and abroad.

*XL supplementary pricing plan.* On December 3, 2003 Matáv introduced the XL supplementary pricing plan which may be ordered in addition to a Bázis, Csevegő or a Sokatmondó pricing plan subscription. For a monthly gross fee of HUF 990, customers using the supplementary pricing plan may generate calls without the payment of any usage fee or call set up charge for local calls up to the first 60 minutes per call (the discount is only offered for voice calls).

*Matáv Open Internet service.* On June 16, 2003, Matáv launched its Internet service based on per-minute pricing. Matáv's Open Internet service offers an Internet access for a per-minute fee without any monthly fee, call set up charge or registration fee. The service is available for every Matáv subscriber via 06 51 622 622. In addition, Csevegő pricing plan subscribers can apply half of their monthly fee toward on-line time, if the new service dial-in number is used to access the Internet.

#### *Public Telephones*

As of December 31, 2003, Matáv Rt. operated 28,799 public payphones, representing a penetration rate of approximately 3.8 per 1,000 inhabitants in Matáv Rt.'s service areas. The traffic tariffs charged for calls from public payphones are at a premium to those charged to fixed line subscribers.

#### *International Telephone Services*

International telephone services consist of outgoing and incoming international telephony traffic, including voice and switched transit traffic through Hungary. In 2003, outgoing international telephony traffic generated revenues of HUF 9,473 million before intersegment eliminations, and incoming international telephony traffic generated revenues of HUF 13,040 million before intersegment eliminations.

#### *Products and Services*

Matáv provides international calling access to its fixed line telephony subscribers and to subscribers of other local telephone operators and mobile service providers. Matáv's Hungary Direct and Country Direct services permit customers to charge calls made from 50 countries abroad to their home phone numbers. In 1998, this service was widened with a postpaid international calling card.

International toll-free service was launched in 1998. This service enables the caller to make international calls free of charge to and from 36 countries, while the call charges are covered by the subscriber of the toll-free number. Universal international toll-free service was launched in 2003. This service is available from 21 countries and enables the subscribers to be called on a unique universal number free of charge from abroad.



In June 2000, Matáv introduced the international prepaid calling card, "Barangoló", which allows customers to make phone calls, including IP based calls, in 40 countries. This service enables customers to call from touch-tone payphones in Hungary and abroad until the card expires.

#### Traffic

The following table sets forth information regarding international telephony traffic to and from Hungary, transited by Matáv Rt., including other LTOs' and mobile service providers' international traffic and transit traffic through Hungary. In addition to international traffic through fixed lines and mobile service providers, the figures also include traffic based on IP technology, but do not include traffic through international leased lines.

	Year ended December 31,					
	2001		2002		2003	
	(millions of minutes, except for percentages and ratios)					
<b>Outgoing traffic:</b>						
Germany and Austria	114.9	35.9%	94.5	33.4%	87.7	32.8%
Neighboring countries other than Austria	56.6	17.7%	52.2	18.4%	56.9	21.2%
United States	14.8	4.6%	11.1	3.9%	11.2	4.2%
United Kingdom	16.5	5.2%	16.0	5.6%	13.9	5.2%
Italy	19.4	6.0%	16.6	5.9%	16.6	6.2%
All other countries	97.9	30.6%	92.7	32.8%	81.3	30.4%
<b>Total outgoing traffic</b>	<b>320.1</b>	<b>100.0%</b>	<b>283.1</b>	<b>100.0%</b>	<b>267.6</b>	<b>100.0%</b>
<b>Growth in total outgoing traffic (% per annum)</b>		<b>(5.5)%</b>		<b>(11.6)%</b>		<b>(5.5)%</b>
<b>Incoming traffic:</b>						
Germany and Austria	115.5	28.5%	117.4	31.8%	122.4	36.6%
Neighboring countries other than Austria	45.4	11.2%	41.7	11.2%	36.9	11.0%
United States	65.5	16.2%	43.5	11.8%	35.6	10.6%
United Kingdom	40.3	9.9%	33.9	9.2%	25.9	7.7%
Italy	20.3	5.0%	18.3	5.0%	16.6	5.0%
All other countries	118.1	29.2%	114.3	31.0%	97.3	29.1%
<b>Total incoming traffic</b>	<b>405.1</b>	<b>100.0%</b>	<b>369.1</b>	<b>100.0%</b>	<b>334.7</b>	<b>100.0%</b>
<b>Growth in total incoming traffic (% per annum)</b>		<b>(15.0)%</b>		<b>(8.9)%</b>		<b>(9.3)%</b>
<b>Ratio of incoming to outgoing traffic</b>		<b>1.3</b>		<b>1.3</b>		<b>1.3</b>
<b>Transit traffic (millions of minutes)</b>	<b>88.4</b>		<b>87.0</b>		<b>58.1</b>	

A substantial portion of international traffic in terms of minutes consists of calls to and from Germany, Austria, the United States, the United Kingdom and Italy, which, in the aggregate, accounted for approximately 48.4 percent of the outgoing traffic and 59.9 percent of the incoming traffic in 2003.

In 2001, 2002 and 2003 the volume of incoming traffic exceeded the volume of outgoing international traffic. The Company believes that outgoing traffic did not reach the volume of incoming traffic because customers are increasingly using leased lines and private branch exchange services such as call blocking. In addition, both outgoing and incoming international traffic handled by Matáv Rt. decreased as alternative service providers started to offer both call origination and call termination services for other domestic fixed line and mobile operators in Hungary. The decrease in the international traffic from 2002 to 2003 was also due to the establishment of the independent international links in 2003 by Westel, that allowed Westel to



independently handle international call origination and termination traffic. Westel's international traffic data is not included in the table above.

Despite the increasing competition in the international transit market, Matáv carried a considerable amount of switched transit traffic between Western and Central/Eastern Europe. In 2002 and 2003, international transit traffic decreased compared to the previous year's figure. This decrease was due to the liberalization in the neighboring countries, which made it possible for new telecommunications operators to handle some of Matáv's previous transit traffic.

#### *Tariffs*

The call charge for an international call, like that for a domestic call, contains two elements: a call set-up charge and a traffic charge measured in seconds based on the call's duration. On September 1, 2002, Matáv introduced eleven international tariff zones instead of the former six zones to better differentiate the rates of the international fixed line and mobile calls. International tariffs decreased on average both in 2002 and 2003 and the Company expects to continue to lower its international tariffs to stimulate usage.

*Settlement Arrangements.* Under bilateral settlement arrangements, Matáv pays other carriers for the use of their networks for outgoing international calls and receives payments from other carriers for the use of its network for incoming international calls. In Europe, such settlement arrangements fall under the general auspices of the International Telecommunications Union. Settlement payments, which are generally denominated in Special Drawing Rights ("SDR"), are calculated using a currency basket in which U.S. dollars have the greatest weight. Due to the large exchange rate fluctuations of the SDR caused by the recent volatility of the U.S. dollars, Matáv started to shift its accounting rate agreements to euro based arrangements. As the Company's important European partners were in agreement with this change, Matáv will continue these efforts in 2004 as well.

#### *International Telecommunications Hub*

Matáv believes that Hungary is well located to serve as a telecommunications gateway between Eastern and Western Europe. Matáv has two state-of-the-art international gateways as well as fiber optic cable connections serving 12 border crossings. These fiber optic cable connections use synchronous digital hierarchy transmission facilities. The Company has X.25 links, which are used for packet switched data transmission with 83 international networks. It also has ISDN connections with 52 international networks. In order to increase the utilization of its transmission network, Matáv offers advantageous pricing plans for dedicated transit services via Hungary. Matáv has launched its own Dense Wavelength-Division Multiplexing ("DWDM") backbone network and is DT's partner in Delivery of Advanced Network Technology to Europe ("DANTE"), which provides 2.5 Gbit/s transmission paths for interconnecting Budapest and Zagreb into the European research and educational network, GEANT.

To seize the opportunities presented by liberalization of the telecommunications market in Romania, Matáv established interconnections with major Romanian alternative service operators and network service providers in order to offer transit services towards Western Europe. In addition, Matáv uses its own point of presence in Austria, which enables the Company to engage in telephone and Internet business with alternative telecommunications carriers located in Vienna. Matáv is present at the Vienna Internet Exchange (with dedicated circuit for Internet data exchange) and has peering arrangements with approximately 60 ISPs there. Matáv has direct Internet peering connections with Ukraine and Slovakia and provided high-capacity international Internet transit service to Internet Service Providers ("ISPs") in Moldova and Macedonia.

*Leased Lines*

Revenues from leased lines totaled HUF 21,286 million in 2003, HUF 20,377 million in 2002 and HUF 18,010 million in 2001, in each case before intersegment eliminations. Matáv is the principal provider of leased lines in Hungary.

Leased line service establishes a permanent connection for the transmission of voice and data traffic between two geographically separate points (point-to-point connection) or between a point and several other points (point-to-multipoint connection). These points can be either all within Hungary or partly in Hungary and partly abroad.

The Company leases lines to other local telephone operators and mobile service providers, who use such lines as part of their networks. It also leases lines to providers of data services. In addition, the Company leases lines to multi-site business customers who use leased lines to transmit voice and data traffic among their respective sites.

The Company offers a broad variety of standard analog and digital lines for lease, including two-wire and four-wire analog lines and digital lines with capacities from 64 Kbit/s to 155.0 Mbit/s. Matáv also offers high capacity customized digital lines to other telecommunications providers.

*Flex-Com.* Since 1996, Matáv has offered Flex-Com, domestic and international digital leased lines with managed back-up systems that are dedicated to transmitting data. In 1998, the Company launched the Flex-Com Network Management Service (Virtual Switched Network) network management system and ISDN-Flex and Voice-Flex services. In 1999, higher quality (Gold and Silver), secure access, and quick installation (Express, Profi) Flex-Com services were introduced. The Gold and the Silver quality services increase the annual availability to 99.9 percent and 99.7 percent respectively, as compared to the 99.5 percent annual availability of the Flex-Com basic service. The secure access provides two-way subscriber access through separate routes or transmission media at one termination point of the connection. The quick installation services are connected within ten days (Express) or within five days (Profi) as compared to the normal provisioning time (20 days). In 2000, Matáv launched two new services. Flex-Com high-speed (E3) access service provides 34 Mbit/s central access for the main site of a large enterprise network. City-Voice service is a version of the Voice-Flex service, which offers hot-line voice and fax communication capabilities on the managed leased line network between two customer premises.

Matáv further widened the range of access options to the service in 2002. It developed and launched the outdoor Flex-Com subscriber access and the Kiloflex P-type subscriber access. The outdoor access provides an opportunity for the outdoor installation of terminating equipment of lines with maximum 1,984 Kbit/s, focusing on the demands of mobile service providers. In the speed range from 192 Kbit/s to one Mbit/s, Kiloflex P provides a cheaper access than the previous subscriber access, for example for IP purposes.

In 2002, Matáv launched the Service Level Agreement ("SLA") report service of Flex-Com and Frame-Flex, which offers the monthly and annual printed reports of the SLA parameters specified in the customer contracts. The SLA report, as an additional service, shows our customers the monthly and annual fulfillment of the commitments identified in the SLA. The reports are generated automatically in order to regularly monitor and check the actual service quality. In 2003, Matáv launched the Web SLA service, which provides SLA reports through the Internet.

Matáv increased the number of its Flex-Com connections from 8,920 as of December 31, 2000 to 11,480 lines as of December 31, 2003.

*Frame-Flex.* Matáv also uses its managed leased line network to offer Frame-Flex, a public frame relay service that is particularly suited to customers who transmit data in bursts, such as connections between local area networks. As of December 31, 2003, Matáv had 827 Frame-Flex connections. In 2000, Matáv introduced LANConnect, a frame relay based managed router service. LANConnect is primarily targeted at small and medium size enterprises allowing them to seamlessly interconnect their Local Area Networks ("LANs").

*High Speed Leased Line ("HSL")*. The HSL service provides permanent, digital, transparent, point-to-point leased line service between service access points ("SAPs") which meets the ETSI Open Network Provision ("ONP") specifications. The connections are established by the service provider according to the needs of its customers. Transmission rates provided by the HSL service are 2, 34 and 140 Mbit/s. In 2001, Matáv enlarged its HSL services portfolio by offering new speed elements at 45 and 155 Mbit/s. Matáv increased its HSL connections to 522 by December 31, 2003 compared to 432 at December 31, 2002.

As an addition to the High Speed Leased Line portfolio, Matáv introduced a Wavelength Division Multiplexing ("WDM") technology based premium service, Gigalink, which provides an even higher speed (622 Mbit/s) leased line service to business customers and to other service providers.

The Company's leased line customers pay a one-time connection fee based on the type of line leased. Monthly subscription charges vary with the type and length of line leased and, in some cases, with the term of the lease. With the exception of leased lines required for connection with other networks, leased line tariffs are not subject to regulation. As part of the overall rebalancing of its tariffs, Matáv has reduced its leased line tariffs in real terms over the last few years in response to competition, which partly offset the revenue increase generated by volume and bandwidth increases of the leased line services.

#### ***Data Transmission and Related Services***

Revenues from data transmission and related services amounted to HUF 22,550 million in 2003, HUF 17,597 million in 2002 and HUF 15,184 million in 2001, in each case before intersegment eliminations. Data transmission and related services consist primarily of data transmission and network services for business customers, such as financial institutions and insurance companies, and, to a lesser extent, residential customers. The market for data transmission and related services in Hungary is highly competitive. The Company is the leading supplier of data transmission and related services in Hungary.

Matáv's revenues from data transmission have grown significantly as a result of both the development of the Hungarian economy and the Company's increasingly sophisticated services. Matáv expects the market for these services to grow with the proliferation of personal computers and increasing consumer demand. Matáv believes that the ability to offer new data products and services will be critical to competing effectively in the future, particularly with respect to business customers.

*Internet.* Axelero, Matáv's fully owned ISP subsidiary, increased its subscriber base by 40.5 percent to 210,680. Axelero is the largest Internet service provider in Hungary with an estimated 44 percent market share based on the number of dial-up subscribers. Axelero also offers Internet services based on ADSL technology as well as access through cable television, to provide residential and business customers with fast, broadband Internet service at affordable prices. The number of Axelero's broadband (ADSL and cable television) customers has nearly quadrupled and reached 77,760 as of December 31, 2003 compared to 20,913 a year earlier.

Axelero maintained its market leader status in residential, corporate and content services market segments.

In 2003, the number of Internet users increased dynamically, Internet penetration rate among the population aged 14 and above reached 22 percent, while 12 percent of Hungarian households were connected to the Internet. In parallel, Personal Computer ("PC") penetration rate also improved, providing a basis for further growth potentials. Costs of using the Internet decreased by 25 percent, which also contributed to the results achieved in 2003. Axelero is committed to accelerate Internet penetration growth and invests significant amount of resources in attractive and innovative content development. The efforts seem to be fruitful, as the popularity of the [origo] portal has increased significantly. Additionally, the government plays a critical role besides the private sector in creating favorable conditions for the expansion of the Internet. Axelero joined the Government's Sulinet Expressz program, which provides tax credit to students and teachers on PC purchases. Axelero offered a free trial Internet access service to Sulinet Expressz configured PC's. The [origo] portal supported the initiative by creating a training site to educate beginners.

The accelerated broadband expansion in Hungary can help to utilize the full potential of the Internet and attract the number of educated users who consume more content and services. While an average Internet user spends 24 hours on-line monthly and only 9 percent use the Internet for electronic administration, a broadband subscriber spends 163 hours on the net and 35 percent use the Internet for electronic banking or shopping. Axelero Internet research shows that an increasing number of households skip dial-up technology and start to use Internet on broadband.

The growth of Axelero was greatly fostered by [origo], the most frequently visited portal in Hungary in excess of one million hits per day in November 2003. On a record-breaking day of November 24, 2003, 418,000 visitors generated 10 million page impressions ("PIs") as opposed to 4.6 million PIs on the same day in 2002. The extraordinary growth was the result of introduction new services and contents, including [origo]"shopping mall", multi-player strategy games and a film column. Axelero Internet is concerned with social responsibility issues and made [origo]accessible to the blind and near-sighted visitors.

As of October 2003, Axelero became the majority owner of Marketline, which provides the dominant horizontal electronic marketplace service in Hungary. In 2003, the total volume of on-line auction service (reverse purchasing auction) reached HUF 60 billion in Hungary.

Other important results of Axelero during 2003 included:

In March 2003, Axelero launched new products, including packages bundling Internet and telephone usage costs. As a result of the new portfolio, customers can access the Internet at 25 percent lower costs;

In May 2003, Axelero entered Invitel (formerly known as Vivendi) service areas with ADSL and Kombi products;

In July 2003, Axelero joined Matáv's "Small town ADSL program";

In September 2003, Axelero implemented a new e-mail system, aimed to increase service level and reliability. Automatic virus scan software was put into operation for enhanced security. Value added services (extra storage place and spam filter) were launched on Freemail, the most popular free e-mail service in Hungary.

To help stimulate demand and promote wider Internet usage, Matáv offers discounted Internet packages from August 1, 2002. There is one package that contains 15 hours of off-peak time Public Switched Telephone Network ("PSTN") access to the Internet for HUF 1,240 exclusive of Value Added Tax ("VAT") and another one that contains 40 hours of off-peak time PSTN access to the internet for HUF 3,200 exclusive of VAT. These schemes were developed in cooperation with the government in order to contribute to the development of the Internet community and to stimulate usage.

*Datex-P.* Matáv offers Datex-P, a packet-switched data transmission service based on the X.25 protocol. As of December 31, 2003, Matáv had 3,636 Datex-P terminals. The service provides low to medium speed domestic switched data communications services with international connectivity to business customers. As a result of the proliferation of new technologies, growth in the number of subscribers has stopped. In order to extend the lifecycle of the product and maintain profitability, network optimization and cost reduction were the major objectives in 2003.

*rEDInet.* This service allows editing of business documents electronically, quickly, accurately and with full security. The technology of the Electronic Data Interchange ("EDI") service is used in more than 25 countries. Matáv also provides professional training and consultation services to its rEDInet user business partners. The rEDInet covers more than 80 percent of the traditional EDI market in the Fast Moving Consumer Goods ("FMCG") sector. In recent years the growth of the traditional EDI market has slowed. Further growth opportunities may appear through providing of Internet-based solutions with lower costs and more simple operations to those companies, which do not require implementations integrated to their company information systems.

*Security Services.* On July 5, 1998, Matáv established Matávör Kft., a wholly owned subsidiary, to provide security-monitoring services. On June 15, 2001, Matáv and Group 4 Securitas Kft. established Group 4 Matávör Rt. The operations and customers of Matávör Kft. were taken over by the newly established associated company, in which Matáv owns a 50 percent interest. As of December 31, 2003, Group 4 Matávör Rt. had 10,831 customers.

*Matáv ADSL.* ADSL is a continuous, high-speed Internet access services based on the Asymmetric DSL technology. The service bundles cost efficient broadband Internet access with telephony service over existing copper wires. Matáv sells these services mainly on a wholesale basis to ISPs, which in turn distribute the services to residential and small business customers. The service has been available in certain parts of Budapest since September 1, 2000, and its coverage is rapidly expanding. In 2003, this service had significant growth with the number of ADSL connections reaching 103,564 by December 31, 2003 from 6,201 at December 31, 2001.

Matáv's ADSL service family that provides high-speed Internet through a broadband access was introduced in September 2000. Matáv's ADSL products explicitly serve high-speed Internet access; with their help a constant connection can be established that may be up to 20 times quicker than traditional dial-up or ISDN connection.

In 2003, Matáv implemented a major infrastructure expansion project in order to accomplish its Internet market goals. A large amount of investment was used for the roll-out of broadband Internet. As a result of these steps, 175 towns were connected to the service in 2003, and broadband access is now available for more than two-thirds of the fixed line subscribers in Matáv's service area.

The proportion of Hungarian broadband Internet users to the total Internet users has reached a high level even in comparison to the Western European standards, as 33 percent of domestic Internet subscribers have a broadband connection to the Internet. In Matáv service area, every fifth Internet access is an ADSL connection. In the East Central European region, Matáv is the market leader in terms of total ADSL lines; with regard to ADSL penetration Hungary ranks second in the region, following Estonia. The proportion of ADSL Internet users is 20 percent, and this figure exceeds the EU average of 19 percent.

*Small town ADSL program.* The successful "Small town ADSL program" was launched in 2003. Through regional development activities catered to market demand, this program has made ADSL access available in small towns and villages that are often economically less developed. The goal of the "Small town program" is to identify and serve towns and locations that show a significant interest in ADSL. In the first phase of the program (started on June 23, 2003), prospective users from 42 locations could register

their requests. The list of towns included in the program is continuously expanding. So far, about 200 towns have signed up for the program.

*Satellite DSL.* Satellite DSL is a broadband Internet connection via satellite. This service can provide a high-quality access to the Internet for customers who live in areas not yet covered by the ADSL service. The Satellite DSL service ensures a broadband Internet connection via satellite in areas where no other broadband Internet access is available. With the help of satellite connections, the service multiplies the download speed of the already existing Internet access; when using this service, Internet contents may be downloaded with a speed of up to 768 Kbit/s.

*Matáv EasyNet.* On February 21, 2003, Matáv launched its EasyNet product, a wireless broadband Internet solution based on the Wi-Fi technology for public site owners (e.g. hotels, conference centers and restaurants). It does not contain end-user authentication, therefore in areas with radio coverage anyone may take advantage of the broadband Internet service with an appropriate end user device.

*Matáv EasyNet Plusz* was launched on August 1, 2003. This service provides significant additional capabilities compared to those offered by Matáv EasyNet. The most significant feature is the end user identification, as well as the use of prepaid cards, which allow the use of the wireless broadband Internet service. EasyNet Plusz cards are available in three various forms offering fixed time Internet access (1-hour, 5-hour, 24-hour) to the end users and may be used at any time up until the expiry of the card. At the end of 2003, there were 13 Public Hot Spot Sites in operation (6 hotels, 5 Matáv Points and 2 others).

*IP Connect.* In September 2000, Matáv introduced IP Connect service. This service is a complete solution for ISPs providing transport and access facilities to IP traffic. It includes the provision of ports in the service area, required for the subscribers of ISPs to dial-in from analog or ISDN lines. The service also enables leased line access, and it ensures that traffic will be forwarded to both domestic and international switches as well as to the domestic switch of a particular ISP. The domestic switch of the ISP is connected to Matáv's IP network via a leased line. In order to maintain market share and competitive position, a new bundled service, called Symmetrical Internet was introduced in 2003, which includes access and IP/Internet service.

*IP Complex Plus.* IP Complex Plus is an IP based Virtual Private Network ("IP-VPN") service. IP Complex Plus service is offered to retail and wholesale customers having multiple remote sites. This service enables them to establish data traffic between sites without the need of setting up "point-to-point" connections between two sites. Customers' VPNs are secured since they remain separated from each other. The share of this product is relatively low in the data service portfolio, but the growth rate of its revenues was remarkable in 2003. The development of supplementary services, such as ISDN backup, integrated voice/data, ADSL/SHDSL access and dial-up access to IP-VPNs make this product more attractive to a growing number of business customers.

*MultiLAN.* Matáv's system integration services are primarily targeted at business customers with separately located branch offices. It includes the installation of LANs at customer premises and the provision of Wide Area Network ("WAN") services. Matáv provides integrated network management, fault clearance and customer support for the LAN and WAN segments.

*International data products.* The Company provides signaling links for mobile operators to facilitate international roaming. Matáv also sells international leased lines, including international managed leased lines, international ISDN, X.400, X.25 and telegraph services. The sales of international leased lines are steadily growing, partly due to the introduction of one-stop-shopping agreements, whereby customers can order from and pay for the service at one end-point of the connection, which eliminate the need to deal with multiple service providers. International Internet connectivity was enhanced in 2000 in order to provide services for Internet service providers. In 2003, the capacity of international Internet connections reached one Gbit/s. Since the end of 2003, Matáv no longer provides international telex services.



### ***Fixed Line Telecommunications Equipment Sales***

Matáv distributes an extensive range of telecommunications equipment, from individual telephone sets to facsimile terminals, PBXs and complete network systems, through a network of customer service centers. In addition to stand-alone phoneset sales, Matáv sells various packages combining telephone sets with telephone lines or pricing plans.

Cardnet Rt., in which Matáv acquired a majority interest in 1998, sells point of sale terminals. Matávcom Kft., Matáv's fully owned subsidiary, sells PBX equipment.

Sales of fixed line telecommunications equipment generated revenues of HUF 2,949 million in 2003, HUF 3,671 million in 2002 and HUF 3,582 million in 2001, in each case before intersegment eliminations. Matáv does not manufacture telecommunications equipment but resells and leases equipment manufactured by other companies.

The telecommunications equipment sector is highly competitive and characterized by rapid technological innovation. Matáv believes that the supply and service of telecommunications equipment are integral parts of being a full service telecommunications provider and are necessary for the expansion of its customer base. In addition, these activities permit Matáv to ensure that technologically advanced equipment required for new services is available in the Hungarian market.

### ***Other Revenues***

Other revenues include cable television revenues, construction and maintenance services and other miscellaneous revenues, such as subsidies receivable from the Universal Telecommunications Support Fund. Other revenues generated HUF 29,412 million in 2003, HUF 28,866 million in 2002 and HUF 18,986 million in 2001, in each case before intersegment eliminations.

Matáv has consolidated its cable television ("CATV") group into three entities providing cable television services in Hungary. The asset management holding company of the CATV business is Investel Rt. The most significant (majority owned) company of Matáv's CATV group is MatávkábelTV Kft. ("MatávkábelTV") established by Matáv on July 1, 1998. It began providing cable television services on January 1, 1999. Through network development and acquisitions, Matáv's CATV group significantly increased its number of cable television customers during the past four years, and strengthened its second position in the market. The CATV group had approximately 362,000 subscribers as of December 31, 2003, out of which MatávkábelTV had 263,000, compared to about 267,000 on December 31, 2000. MatávkábelTV offers 42 television and radio channels in three program packages in its network. As a result of the price-based competition in the cable television market in Hungary, especially in Budapest, new customers are often connected without connection fees. Where the networks allow, Matáv's CATV firms - in cooperation with ISPs - offer broadband Internet services. In most cases, CATV firms provide a network service for ISPs. The number of Internet subscribers through Matáv's cable television network was approximately 9,600 on December 31, 2003. MatávkábelTV's cable television activities benefit from Matáv's long term relationship with the customers, its thorough market knowledge as well as its strong brand name. The main goals in this area are to increase market share through further acquisitions, connect additional customers within existing service areas, improve the quality of network and increase ARPU.

In 2002, Matáv introduced the Audiofix (Drop Charge) product, which is an Intelligent Network ("IN") premium rate service enabling content providers to offer content services for fixed call rates. The product is mainly used in the media's call-in programs. The product has been very successful due to the introduction of reality shows and other interactive programs on the Hungarian television channels.

Matáv constructs fixed telecommunications networks and offers network maintenance services to other telecommunications operators in Hungary. These construction and maintenance services are ancillary to the construction and maintenance of Matáv's networks.

Matáv carries out its construction through subcontractors. The majority of construction revenue is derived from optical network construction, network construction related to subscriber connections and project planning. In addition, Matáv's fully owned subsidiary, Matávcom Kft. is also engaged in complete network construction activities.

Matáv owns a 25 percent interest in Magyar RTL Televízió Rt. ("MRTL"), a national terrestrial television broadcaster entitled to provide commercial television programs but not to engage in broadcast diffusion or distribution activities. CLT-UFA S.A. owns 49 percent, Pearson Netherlands B.V. owns 20 percent and IKO Production Média Szolgáltató Kft. owns six percent of MRTL. MRTL has a concession for a period of ten years with an option for a five-year extension. The Program Provision Agreement was signed on July 9, 1997, the starting date of the license. MRTL operates a channel under brand name RTL KLUB.

Since its launch in 1997, RTL KLUB has rapidly established a strong position in Hungary's television market. Market share among the targeted age 18-49 audience rose substantially from 1997 to 2003, from 21 percent to 33 percent considering the whole day and from 20 percent to 40 percent during prime-time (between 7 and 11 p.m.). MRTL has successfully converted its leading audience result into television advertising market share.

RTL KLUB seeks to maintain and increase audience share through investing in local productions, including successful internationally licensed programs, and through its continued long term relationships with major film distributors, including Warner Brothers, Fox, Buena Vista and Columbia. MRTL won the right to broadcast Formula One races for five years commencing in 2002. In response to the main competitor's launching of "Big Brother", MRTL started its own reality show: "Való Világ" (Reality World) in 2002. Due to the success of the program, RTL KLUB broadcasted the second and launched the third series of this reality show during 2003. Való Világ enabled MRTL to generate increased non-spot (prime-rate audiotex and SMS) revenues and contributed to the development of RTL KLUB brand name.

#### **Mobile Telecommunications Services Segment**

Matáv's mobile telecommunications services generated revenues of HUF 254,141 million in 2003, HUF 232,612 million in 2002 and HUF 198,947 million in 2001, in each case before intersegment eliminations. Until June 30, 2003, Matáv provided mobile telecommunications services in Hungary through two subsidiaries, Westel and Westel 0660, each of which was 100 percent owned by Matáv. On June 30, 2003 Westel 0660 terminated the provision of analog cellular telecommunications services and was merged into Westel on November 30, 2003. Westel remained the sole subsidiary of Matáv providing mobile telecommunications services in Hungary.

As of December 31, 2003, Westel accounted for an estimated 47.4 percent of the total Hungarian mobile telephony market in terms of subscribers. The penetration rate of digital mobile telephone services in Hungary increased from 30.0 percent at December 31, 2000 to 78.5 percent at December 31, 2003.

On March 22, 2004, Matáv's Board of Directors has taken the decision to rebrand Westel as T-Mobile. The official name of Westel will change to T-Mobile Hungary Telecommunications Co. Ltd. (in Hungarian: T-Mobile Magyarország Távközlési Rt.) from the beginning of May 2004.

Westel and T-Mobile International (the mobile telecommunications division of DT) have acted in close co-operation for a number of years. The co-operation both in the area of procurement and development of new technologies and services allows Westel to offer its customers a wider range of services and equipment for more competitive prices. The rebranding is the next step in exploiting the service synergy potentials between Westel and the T-Mobile Group. T-Mobile International is one of the largest international groups of mobile operators and is the only mobile communications company providing a seamless transatlantic service to its customers. The subscribers of T-Mobile Hungary will have access to innovative products and services under the T-Mobile brand. In addition, the rebranding will bring the increased convenience of being able to access additional services offered through other T-Mobile networks.

The rebranding does not signify any change or any intention to alter the ownership of Westel, with Matáv remaining the sole owner of the Hungarian mobile company. The Deutsche Telekom Group will be directly involved in the rebranding process, assisting in areas such as marketing communications, corporate identity and design rollout, network update and distribution. The rebranding is expected to result in an improved customer base and reduced churn rate, higher ARPU and roaming revenues and a lower subscriber acquisition cost which all result in an improved EBITDA.

### *Westel*

Westel commenced offering commercial Global System for Mobile Telecommunications ("GSM") digital mobile telecommunications services on March 31, 1994, pursuant to a concession awarded in November 1993. GSM affords high quality digital transmission and is the dominant digital mobile telecommunications standard in Europe. During 2000, Westel (previously known as Westel 900) was rebranded as a service provider on both 900 and 1800 MHz bands. Westel offers basic GSM voice telephony services and a number of value added services, such as voice-mail, call forwarding, SMS, call waiting, conference call, caller identification ("ID"), company call, virtual private network and dual Subscriber Identity Module ("SIM") card. General Packet Radio Service ("GPRS"), which is also known as "2.5G", was introduced in 2001 for Westel's postpaid customers, while Enhanced Data rates for GSM Evolution ("EDGE") was launched in late 2003. Westel also provides GSM-based data and facsimile transmission services as well as SimToolKit applications, mobile Internet services and a number of content services. Westel offers several different service packages designed for different customer requirements, including various pricing plans targeted at low volume residential customers and higher volume business and governmental customers. In 2002, new value added services were introduced, including Multimedia Message Service ("MMS"), Video Streaming, Video Messaging, Mobilbank and mobile purchase.

The prepaid card of Westel, Domino, provided 63.7 percent of net customer additions in 2003. Since the introduction of the SMS for prepaid customers in 1999, Westel has made more value added services available to prepaid customers, such as caller ID, Domino data and fax. Prepaid users witnessed a significant increase in content provision in 2002, as a result of which they are able to use digital services (such as downloading various operator logos, ringtones, etc.) and acquire information on weather, traffic, news, economy, sport, gambling, etc. via premium-rate SMS or Wireless Application Protocol ("WAP"). WAP traffic was further boosted by the introduction of 777mobil, the redesigned website of Westel. SimToolKit applications also became available to prepaid customers, and electronic recharge opportunities are available at a wide range of Automated Teller Machines ("ATMs"), petrol stations, via Internet-banks, Telebanks and Mobilbank.

In 2002, Westel introduced GPRS. In 2003, Westel continued enhancing its value added services, introduced more new products and extended the access of some of its domestic products abroad:

Westel offered international roaming service for its subscribers in 121 countries in 272 networks, thereof 106 networks in 53 countries were available for Domino customers and 37 GPRS networks in 28 countries for postpaid customers as of December 31, 2003.

After a major development in 2002, content provision strengthened again in 2003 from the offering of additional services and contents to customers. Besides WAP, content SMS and premium-rate SMS customers can register for content MMS as well. At the end of 2003, content MMS registrations surpassed 5,000. WAP is used by hundreds of thousands of Westel customers regularly. The number of content SMS subscriptions continuously increased during 2003 and reached over 470,000 subscriptions by the end of the year. Users can register to several content SMS categories like news, traffic, weather, entertainment, gambling results and horoscope. Westel users sent approximately 1.4 million premium rate SMSs per month in 2003.

In 2003, Westel developed its MMS service. As a result, Westel introduced the "MMS-postcard" service, through which customers with MMS-capable phones are able to send their MMS to a postal address as a traditional postcard. Customers already sent approximately 1,000 postcards within the first month of the launch of this service in December 2003.

Since 2003, the Westel Mobile E-mail offers a comprehensive e-mail and calendar solution for small and medium-sized enterprises. Sized to the actual needs of the company, the service requires no investment by the customer and allows colleagues to access their mailboxes in and away from the office, via WAP, SMS or the Internet.

If the customer is not available when called, the "calling-notification" service of Westel sends an alert-SMS to the called phone. This SMS informs the customer about the date and the time of the missed call and also about the caller phone number (if available).

The unique Mobilbank solution of Westel continued its growth in 2003. Both the number of subscribers and the number of transactions increased. The most popular transactions were money transfer and prepaid balance refill.

Customers with certain phones are able to use the newly introduced "SMS-reader": according to the settings made by the customer, an applet on the phone reads out the incoming SMS. The service runs on Nokia 3650 and Nokia 7650 phonesets.

In March 2003, Westel was the first operator in Hungary, and one of the firsts in Europe, to introduce movie ticket purchasing via WAP. This service was extended to SMS in December 2003, enabling Westel subscribers (both pre- and postpaid) to make movie ticket purchases using their own mobile phones by just entering a code.

Prepaid customers of Westel witnessed the extension of value added services: since 2003, prepaid subscribers can register for call holding, conference call, call forwarding and certain location-based services.

Having started the Wireless LAN ("WLAN") pilot in 2002, Westel introduced the commercial service of WLAN in 2003. Customers with properly equipped computers are able to access Intranet and Internet via high-speed (up to 11 Mbit/sec) wireless connection at certain places (currently at Budapest Airport). The target group is mainly key and corporate customers.

At the end of 2003, Westel launched commercial EDGE services, which supplements the GPRS services with higher data transfer speed and capacity. The service is available in certain parts of Budapest. This service is a first step towards implementation of the 3G technologies. Celebrating its 10th anniversary, Westel introduced video-phone call and broadband mobile Internet services in October 2003, which was based on integrated Universal Mobile Telecommunications Service ("UMTS") test network. This demonstrates that Westel is prepared and committed to introduce UMTS in the near future.

Westel encourages customer loyalty with various incentive programs. Gold Cards are awarded to customers based on length of service, and bonus points are awarded to these cardholders based on level of

usage. These points can be accumulated and then redeemed for various products and services in retail stores, via the Internet or through call centers. The price of the selected products and services can be paid by combining cash with points. Loyalty points have a validity period. From August 2003, non-redeemed points credited more than 24 months before become void and deleted. Due to this new measurement, both the activity of the program members and the financial efficiency of the program have increased significantly. Other key elements of retention activities are the Gold Partner Card and Upgrade programs.

The build-out of Westel's mobile network has been substantially completed. It provides nationwide coverage and is being developed to cope with the traffic demand of new, innovative services.

Westel's principal objectives are to maintain market leadership in the growing mobile telecommunications market, expand its brand recognition and focus on providing high-quality customer service.

*Subscribers.* The number of Westel subscribers has grown significantly over the past three years. The table below sets forth information concerning the number of Westel subscribers at the dates indicated:

	<b>As of December 31,</b>		
	<b>2001</b>	<b>2002</b>	<b>2003</b>
Regular subscribers	811,864	850,615	982,460
Prepaid subscribers	1,681,621	2,552,173	2,783,814
<b>Total subscribers</b>	<b>2,493,485</b>	<b>3,402,788</b>	<b>3,766,274</b>
Annual growth in subscribers (%)	55.9	36.5	10.7

The increase in the number of Westel subscribers since December 31, 2001 is attributable to a number of factors, including reductions in handset prices and traffic tariffs in real terms. Growth can also be attributed to installment purchase plans and aggressive marketing. In addition, the introduction of more value added services that are aimed to enhance customer satisfaction increased the retention of the customers.

According to Telecommunications Inspectorate sources, as of December 31, 2003, Westel held approximately 47.4 percent of the Hungarian market for GSM mobile digital services in terms of subscriber base. The Company expects to initiate additional retention and acquisition marketing campaigns to stimulate further subscriber growth and to maintain its market leadership.

*Traffic.* Westel's average traffic per subscriber remains relatively high in Europe at 113.7 minutes per month in 2003. Average traffic per subscriber has declined over the past few years as the subscriber base has expanded to include lower-volume users. During 2003, SMS-traffic witnessed a large increase: 623 million SMS were sent by Westel users during 2003 compared to 586 million in 2002. This amounts to 15 SMS/month/subscriber in 2003.

*Tariffs.* Since January 1998, mobile subscriber tariffs have been deregulated, and carriers have had the freedom to set the level of the various tariff elements (i.e. connection fee, subscription charge and traffic charges). Westel charges subscribers a one-time connection fee, monthly subscription charges, event charges and time-based traffic charges. Customers using prepaid cards do not pay monthly subscription charges. Westel does not charge subscribers for incoming calls, other than calls received while roaming. Westel receives payments from other telecommunications service providers for terminating calls on its network. During 2003, mobile service providers were very active regarding pricing. Westel maintained the widest selection in tariff plans and successfully introduced new tariff solutions and allowances, to acquire new subscribers and increase loyalty. In May 2004, mobile number portability was introduced to the Hungarian market, which may lead to significant changes in terms of retention and acquisition.

*Distribution.* Westel has a strong direct distribution network consisting of 26 Building Value shops, 13 Economy shops and a high-tech showroom. Building Value shops provide full-scale sales, customer service and repair service to the customers while Economy shops primarily focus on sales. Westel has a high-tech showroom called "Enternet". The role of this showroom is to display the new innovations of Westel and the mobile telecommunications industry to the customers enabling them to touch and try the new products, services and handsets. There is also an organization dedicated to major account customers. This directorate consists of 78 sales representatives and serves the major account customers on a segmented basis. Our customers can also purchase Westel products via the on-line shop of the company called Webshop.

In addition to the direct sales channels, Westel also distributes its products and services through indirect sales partners. In 2003, masterdealers (Fotex, Trendex and Matáv) and directly contracted dealers represented Westel in 250 outlets all over Hungary. In December 2003, Westel took over from Fotex its dealer network consisting of 81 outlets. The agreement came into effect on December 31, 2003.

Besides having full-scale sales partners, Westel also sells its prepaid products (prepaid SIM, plastic recharge card, on-line recharge) via major Hungarian retail channels. Westel has a strong relationship with retailers (e.g. Tesco, Cora, MediaMarkt, Metro, Shell, Mol, OMW and Lapker) selling its prepaid SIM cards in 106 outlets and providing prepaid recharge opportunity to the customers at 7,633 outlets.

### **Westel 0660**

Westel 0660 was the sole provider of analog mobile telecommunications services in Hungary. Westel 0660 commenced operations in 1990 and was the only provider of mobile services in Hungary until the commencement of GSM operations in 1994.

Westel 0660 service was based on the Nordic Mobile Telephony ("NMT") standard, which predates digital mobile telephony services, including GSM. The Westel 0660 network covered over 95 percent of Hungary's geographic area.

*Subscribers.* The table below sets forth the number of Westel 0660 subscribers at the dates indicated:

	<b>As of December 31,</b>		
	<b>2001</b>	<b>2002</b>	<b>2003</b>
Subscribers	44,308	23,345	0
Annual growth/(decline) in subscribers (%)	(41.6)	(47.3)	(100.0)

The number of Westel 0660 subscribers decreased from 2000 due to the lack of promotional programs and innovative service offers. Due to the declining demand for NMT handsets worldwide, Westel 0660 was not able to acquire NMT handsets at a reasonable price. This fact limited the ability to retain and acquire customers, so the three GSM operators acquired the churning NMT customers with their attractive pricing plans and handset offers.

On November 12, 2002, Matáv decided to terminate the provision of analog cellular telecommunications services effective of June 30, 2003. This decision was taken in the light of continually decreasing subscriber numbers and the expectation of significant operating losses through the end of the concession period in 2005. Westel 0660 terminated the provision of analog cellular telecommunications services on June 30, 2003 and merged into Westel on November 30, 2003.

## **International Segment**

In December 2000, the Company, on behalf of a consortium, reached an agreement with the government of Macedonia to purchase 51 percent of MakTel on its privatization. The closing of the transaction took place on January 15, 2001 whereby the Company paid EUR 343.3 million on behalf of the consortium in accordance with the agreement. The 51 percent ownership acquired by Matáv was contributed on January 16, 2001 to a newly established Macedonian holding company, Stonebridge.

In accordance with the Deed between Matáv, SEEF and CosmoTelco, the latter two acquired a 6.1 percent and a 7.4 percent ownership respectively in Stonebridge, thereby reducing Matáv's investment in Stonebridge to EUR 301.5 million. Matáv, consequently, had an 86.5 percent stake in Stonebridge, which owns 51 percent of MakTel, thereby Matáv had an effective ownership percent in MakTel of approximately 44 percent.

Pursuant to the terms of the Deed, SEEF exercised its put option relating to 3.05 percent holding in Stonebridge on June 20, 2003 and Matáv paid EUR 21 million to SEEF on July 27, 2003. Following the financial closing of the transaction, Matáv has an 89.51 percent ownership in Stonebridge, with an effective ownership share in MakTel of 45.65 percent.

See "Item 10 Material contracts".

MakTel has been a consolidated subsidiary of the Group since January 15, 2001.

### ***Overview of MakTel's revenues***

In 2003, approximately 49.5 percent of the total revenue of MakTel was derived from domestic fixed line telecommunications services. Mobile services contributed about 32.2 percent, while international telecommunications services contributed about 10.5 percent to total revenues. Various data services (telegraph, X.25, Frame Relay, leased lines, and Internet access) contributed only three percent of the total. Five percent of total revenues were derived from other services.

The revenue stream of MakTel from international traffic shows a decreasing trend reflecting lower traffic and unfavorable SDR exchange rate. The proportion of mobile revenue is decreasing following the entrance of a new mobile operator and decreased usage. Data revenue still represents an insignificant portion of total revenues.

### ***Fixed line Telecommunications Operations of MakTel***

MakTel is the sole fixed line service provider in Macedonia. Its exclusive rights in fixed line telecommunications services will expire in December 2004. These exclusive rights include local, national and international long distance public voice services, voice over IP services, leased line services and building and operating public voice network services. MakTel's objectives for the forthcoming year are to become established as a leader in technology and to provide excellent services with attractive prices in order to prepare for future competition.

During the last three years, MakTel's major operational goals were to digitalize the fixed network and to increase the number of subscribers. The digitalization rate increased from 82.1 percent at the end of 2000 to 100 percent at the end of 2003. MakTel had 584,714 analog fixed lines and 34,522 ISDN channels as of December 31, 2003, and fixed line penetration reached 29.0 percent in Macedonia.

During 2003, MakTel introduced several new pricing plans (Minimal, Chatting, VAS packages, etc.) enabled by introduction of a new billing system.

MakTel provides Internet services through its Internet business unit, MTNet. MTNet has a 54 percent market share in Macedonia. The number of Internet subscribers and the time they spent on the Internet is climbing rapidly. MTNet provides Internet access via the public switched telephone network and leased lines. By the end of 2003, MTNet had 49,040 Internet customers compared to 34,222 as of December 31, 2002, which represents a 43 percent growth. MakTel also provides Internet hosting, Internet design, Internet content-oriented IP applications and portal services. MTNet has established an IP backbone network with points of presence ("PoPs"), allowing customers to access Internet services with a local call anywhere in the country. During 2003, MakTel introduced a new service, Internet Data Hosting Center ("IDHC"), as a center for collocation of customer servers, renting of servers and hosting of applications or content. In addition, ADSL service was introduced at the beginning of 2004.

MakTel also has data transmission services, such as satellite communications, frame-relay, X.25 and audiotex services.

Historically, MakTel, like government-owned operators in other countries, maintained relatively low domestic charges and high tariffs for international calls. Since November 1999, MakTel has been gradually rebalancing its tariffs in accordance with its long term rebalancing strategy. International tariffs are expected to decrease further in 2004, bringing them in line with EU standards prior to liberalization. Local tariffs and basic access charges are expected to increase in order to reflect costs, but MakTel will not seek to exploit the maximum increases allowed by the regulation in order to keep the rates affordable to Macedonian citizens.

MakTel is continuously expanding and improving its access network. MakTel has a fiber optic national long distance network that connects local primary area networks. The Company has implemented three Synchronous Digital Hierarchy ("SDH") rings that serve both the national long distance and international networks. In addition to cost advantages, SDH systems provide a flexible transmission infrastructure with automatic transmission paths. Additional routes of optical cable and SDH systems are being installed in the long distance network and the city networks, increasing both network availability and transmission capacity.

MakTel has installed a modern, packet optimized IP network based on Multi Protocol Label Switching ("MPLS"). The network is fully operational and already carries commercial traffic. This network is the first of its kind in the entire Southeastern European Region, establishing MakTel as an undisputed leader in this field. It uses DPT STM-4 (packets on fiber technology) at its core and packet over SDH STM-1 at the edges. It has nine large PoPs equipped with high-end routers and eleven small PoPs. The network provides a variety of VPN solutions for its business customers, offering secure, scalable remote site interconnection over a shared IP backbone. MakTel realizes the enormous importance of IP for its future and is considering this network to be the best foundation for its future generation of IP based services, combining voice and data and offering versatile multimedia capability.

#### *Mobile Telecommunications Operations of MakTel*

Mobile telephony was a significant growth driver in 2003 at MakTel. MobiMak is the digital mobile service provider of MakTel, which separated from MakTel and became its fully owned subsidiary on June 4, 2001.

As one of the first important steps in its transformation, MobiMak introduced a new brand image to the market. The new image is built on the slogan "connecting your worlds" (connecting past, present and



future, connecting work and private life, connecting family and friends, etc.). MobiMak developed a recognizable brand that is perceived as national, modern, strong, convenient, innovative and supportive.

MobiMak's operations are based on GSM technology in the 900 MHz frequency band. The number of mobile subscribers increased by 43 percent to 523,664 subscribers at the end of 2003 from 366,348 at the end of 2002. The mobile penetration rate also grew significantly, to 29 percent at the end of 2003 compared to 18 percent a year earlier, but it is still well below the European average.

MobiMak entered into a frame contract with the main network and infrastructure vendors whereby MobiMak could fix the prices of different services and products. This frame contract resulted in significantly lower prices for MobiMak to use the services of the main network and infrastructure. Based on the contract, MobiMak initiated a fast network development project in September 2001. By the end of 2003, MobiMak had 441 base-stations on 302 locations. As a result, MobiMak now reaches over 99 percent of the population and 92 percent of the territorial coverage. With implementation of GPRS and MMS, MobiMak introduced the 2.5G technology.

MobiMak put a high emphasis on marketing activities, introducing services based on new technology, such as GPRS, MMS, JAVA games and WAP. New tailor-made pricing plans were also introduced, such as Mobi Elite and Mobi Chat for postpaid and Mobi+ Marathon and Mobi+ Three for prepaid customers as well as Tandem<sup>2</sup> service, which allows activation of two more numbers on the customer's account with only half of the monthly fee. In addition, numerous enhanced services, such as e-recharging of vouchers, Fun SMS, Fun MMS, Flirt SMS, chatSMS, Premium price SMS and m-payment, etc. were introduced in 2003. MobiMak also carried out a series of attractive sales promotions with global brand handsets based upon frame agreements with the main handset vendors, offering to its customers over 70 different types of mobile handsets. The wide range of handset accessories is constantly expanding.

As focus on customer retention, MobiMak continues with its customer loyalty program with valuable benefits for loyal customers.

To measure the effectiveness of the marketing activity, MobiMak introduced a customer satisfaction measurement system, which monitors the satisfaction of the customers on a quarterly basis. Additionally, twice a year, MobiMak conducts Market Potential Research, Focus Group and many other ad hoc surveys.

### **Marketing and Distribution**

While the Hungarian telecommunications market has been fully liberalized since December 23, 2001, the liberalization process started years earlier in data communications, international voice and Internet services. The advent of new competitors was coupled with the mass proliferation of mobile devices, which led to the saturation of the traditional voice business and strong competition in the business communication arena. The high mobile penetration rate is due to the fact that the mobile phone is viewed as a substitute, rather than complementary to fixed telephones because of the relatively low level of disposable income in Hungary.

Having the largest market share makes Matáv vulnerable to losing the largest number of customers, to other fixed line operators, but in particular to mobile operators. To avoid a downward spiral of falling prices and decreasing market share, Matáv had to change its strategy and shift towards competitive pricing plans that are price positioned not only against its fixed line competitors but also against the rapidly increasing mobile package offerings of the mobile vendors.

In 2003, there were significant positive changes in Matáv's market position. At the beginning of the year, the fixed line market was still characterized by a rapid decline of fixed lines, while the mobile market showed increasing penetration. Data transmission services showed minor growth and the spread of Internet was not significant. By the end of the year, however, Matáv managed to achieve a decrease in the rate of customer churn and could stop the decrease of the fixed lines. Matáv was successful in competing against mobile services. Internet usage spread quickly and dynamically, thanks to the launch of the free dial-up Internet service and the strong ADSL campaign - by the end of the year the number of ADSL lines exceeded 100,000.

Matáv's marketing strategy is therefore based on four key objectives:

Strengthening the role of the fixed line service;

Reducing churn;

Boosting broadband penetration; and

Developing a new image of fixed line telephony by developing customized solutions for each segment and identifying business development alternatives.

#### ***Strengthening the role of the fixed line service***

The first year of liberalization ended with only a moderate rise in competition from fixed line competitors due to the unfavorable international investor climate, which nonetheless led the way for the mobile operators to aggressively acquire customers. Launching several optional calling plans ("OCPs"), Matáv successfully transformed service development from technology focused product innovation towards market based product enhancement that requires less capital investment and more customer focus. Backed up by analytical marketing tools Matáv tailored its calling plans to the calling patterns of its various customer segments.

In 2003, competition between and against the mobile service providers was stronger than ever. By the end of the year, mobile penetration rate reached 78.5 percent and increasingly the mobile carriers could only acquire new customers from other service providers. This led to fierce advertising and tariff wars between the mobile carriers. Matáv responded to this new trend proactively by launching the Felező pricing plans. Felező has the same monthly fee as the Bázis pricing plan, however half of the monthly fee can be applied toward voice calls. The new offer proved to be a very effective customer retention tool along with the aggressive mobile advertisements. It also reinforced the concept that the mobile telephone is not the substitute, but a supplementary alternative to the fixed line.

#### ***Reducing churn***

PSTN churn is generated by a) customers' requests, b) lines terminated due to non-payment and c) ISDN service orders. As broadband access services (e.g. ADSL) have become available in recent years and customers become more aware of its availability, migration to ISDN slowed down from levels observed in 2000.

During the first quarter 2003, approximately 75 percent of the disconnected lines were due to the request of customers. The monthly average disconnection was between 10,000 and 12,000 lines. To minimize the cancellation of lines, Matáv launched customer acquisition and retention programs, which so far have been very effective. Due to this activity, by the end of 2003 only 58 percent of disconnected lines were due to the request of customers.

The principal customer acquisition program was the "Szóljon akinek nincs" (Tell us if you don't have one) analog line campaign in August 2003, which resulted in approximately 36,000 new subscribers. The

"HUF 100" line-reconnection campaign was targeted to subscribers who already cancelled their lines earlier. In this action Matáv offered to reconnect them for a HUF 100 fee. As a result, 2,851 subscribers re-activated their lines during September and October 2003.

The most successful customer retention tool to prevent churn was the Felező pricing plan. As it provided a good alternative to the subsidized Minimál pricing plan, it generated new subscribers and many of the Minimál customers migrated to this pricing plan. Other successful action included the ISDN 1 customer win-back campaign, the ISDN loyalty action, the activation of customers having their service suspended and contacting customers who indicated their intention to churn by telephone but not in writing. To further decrease the number of cancelled lines Matáv is working to develop a churn barometer tool, which can indicate whether a customer is likely to churn in the near future.

### ***Boosting broadband penetration***

Matáv considers the promotion of Internet usage in Hungary as one of its main tasks in the present and also in the near future. Its main objectives are to establish and spread a more developed Internet culture, to foster communication, to promote the opportunities offered by the Internet and to reach and support customer segments with low level of disposable income.

Matáv Open Internet is the Company's free dial-up Internet service, which gives additional value to the fixed line and has successfully stimulated fixed line usage. After its launch in July 2003, the service quickly became popular. By the end of 2003, over 62,000 customers had used Matáv Open Internet.

Matáv and Axelero are organizing a free Internet Training Program as part of the "Mindentudás Egyeteme" (Omniscience University) which is sponsored by the Matáv Group and is the most popular scientific forum in Hungary.

The broadband access market is growing dynamically in Hungary. In broadband access market, Matáv is the largest service provider. On Matáv's service area the dominant technology is Digital Subscriber Line ("DSL"), but cable modem is growing rapidly as well. Matáv sells ADSL products mainly on wholesale basis. In the broadband market other types of broadband access are not very significant, however, cable television service providers can be the Company's main competitors.

Matáv had more than 100,000 connected ADSL lines as of the end of December 2003.

To reach this goal Matáv had various campaigns during 2003:

New wholesale offerings in March (including increased speed, 512k/128k and competitive ADSL+IP bundle);

Promotion for ISPs to meet individual sales targets;

Launch of retail (Matáv) ADSL packages;

"Small municipalities program" (involvement of customers in ADSL coverage enhancement);

ADSL image umbrella, benefit communication; and

ADSL year-end sales campaign.

### ***Developing a new image of fixed line telephony by developing customized solutions for each segment and identifying business development alternatives***

*Segmentation at Residential Lines of Business ("T-LoB").* In addition to the residential segment, T-LoB defined micro-, small- and medium-sized enterprise customer bases. For these segments, targeted,

cost effective product developments and communication methods were executed. In 2003, several segment specific programs were launched:

Matáv Discount Coupons can be used to reduce the bill, either in a lump sum or on a regular basis with the coupon's value. Its virtual form offers a flexible, mass discounting option for large Matáv customers. Its physical form may be handed over to customers and it may be converted into a one time discount per card (with further upgrade for multiple discounts);

Prepaid Internet access is a cheap Internet product without the telephone- and Internet monthly fee. It is targeted primarily for those customers who only maintain their lines for availability yet generate more than 6 hours per month of on-line usage;

Co-branded credit card (RUBIN) is a credit card, calling card and direct debit card for telephone bills in one. It aims to increase the perceived value of the fixed line with the ease to get credit. It also serves as a calling card with tariffs same as the ones in the subscribed package of the cardholder; and

Residence parks equipped with telephone lines, in which only subscription is necessary to get telephony services.

*Segmentation at Business Lines of Business ("B-LoB")*. The business customer base served by B-LoB (Top 5400) comprises large and mid-size corporate customers. The two customer groups demand different services due to their market and corporate features.

The Top 400 customer base is more difficult to approach as the market of these companies is saturated, consequently they are not likely to change their existing infrastructure. They keep contact with typically large international and domestic system integrators. These market conditions dictate direct sales for Top 400 with regards to Matáv products and in case of solutions co-operation is necessary with system integrator partners. Therefore, Matáv Rt. can best serve this segment by being a subcontractor to large system integrators.

In the Top 5000 customer base it is the Company's aim to improve the efficiency of direct sales as the telecommunications and Information Technology ("IT") demands of these customers can less and less be satisfied with mass products. The market trends of the recent year reflect that these customers would like to find solutions for more and more complex problems they meet in their business processes with the combined help of these two areas. To meet this demand, the B-LoB marketing organization developed integrated business solutions from existing Matáv telecommunications products and services as well as from the products of selected IT partners. As a part of this work, Matáv endeavored to get to know the business processes of the customer base as deep as possible to be able to develop real solution for their demand, in which IT and telecommunications technologies are combined. Matáv concluded partnership strategic contracts with leading IT companies, such as Albacomp, Avaya, Cisco Systems, HP, IBM and Microsoft, whose products are also elements of the Matáv solutions.

The tailor-made individual solutions ensure several advantages to the customers: a single contract, one stop shopping, foreseeable and lower costs, high quality, continuous support and development as well as customized invoicing.

In the second half of 2003, the following solutions were developed:

*Remote access solution.* Remote access or tele-work in the global market has become a business strategy and a power, which reorganizes the workplace, and its launch and adoption may mean competitive advantage and increased efficiency. The solution makes it possible that the corporate or public institution IT users can access their centrally stored working documents from home and

modify them via electronic correspondence or even through the Internet. In case of remote access, security is a key issue, as the corporate data assets must not be accessible to unauthorized third parties. All elements of the Matáv solution offered were developed and selected with security as high priority.

*Customer care solution package.* The customer care solution package is primarily offered to service providers with a large customer base. Certain elements of the modular package ensure the better use of workforce and improve the quality of customer relations. Developing the complex system may take place in several steps and it is also possible to use a lease construction launch. The solution also includes generic telecommunications products in addition to special call center products.

*Security technology solution.* Matáv's security technology solution allows for the launch of security systems operating on data communications networks, which help to reduce the risk of crimes and natural disasters. The application of security technology equipment was not only required by law, but also makes the object a more comfortable and secure place for the users of the building, since the events taking place may be monitored and in many cases emergencies may be prevented.

*Shared Internet solution.* The Shared Internet solution supplements the intelligent building elements offered by Matáv - such as the computer and telephone networks, fire alarm, entry system, video surveillance system, the possibility of amplifying and video conference - with a broadband Internet connection, which is primarily useful for the real estate maintenance and leases. This solution enables the building maintenance staff to share the Internet connection with a suitable device among the lessees and similarly to a voice service - by creating added value - they can offer a higher quality, more sophisticated service portfolio to their existing and future customers.

*Hotel solution.* With the development of the complex hotel solution package, Matáv's objective was to assist its customers operating in the hotel industry to find their way in the various technologies and ever increasing number of info-communications solutions. The applications offered by the developed service package view the hotel as a complex unit, offering solutions to almost any problem that may arise.

*Business solutions for commercial chains.* The effective commercial activity is based on the detailed development and co-ordination of the sales process elements, on the evaluation of the emerging information as well as its further utilization. For all of this, efficient info-communications solutions are essential. By integrating its own expertise with its partners such as Albacom, HP, IBM, Microsoft and Avaya, Matáv created a solution package for commercial chains.

Realizing that the telecommunications and IT needs of this customer group increasingly call for standardized management and service, Matáv offers them integrated telecommunications solutions, which fully meet their variable needs. For the successful sales of these solutions, the Company must be aware of the corporate processes and business characteristics of its small and medium size enterprise ("SME") customers. Therefore, in order to provide high quality service to the customers, Matáv places a strong emphasis on the segmentation of the customer base by industrial branches. In line with this, Matáv aims to develop an organizational structure, which ensures the effective information gathering on customers as well as the fulfillment of their individual, integrated telecommunications requirements. In the sales organization, besides the region-based distribution, the sector-based distribution received a more marked role and as a result, the service of the customers is now carried out in teams. For the fulfillment of individual needs, Matáv bundles such solution packages from its existing product portfolio and by using the products of its partner companies, which allow for the high quality service of both the telecommunications and IT needs of the SME customers.

## Edgar Filing: HUNGARIAN TELECOMMUNICATIONS CO LTD MATAV - Form 20-F

Matáv T-LoB has seven retail sales channels to ensure total market coverage for more than its two million residential and business customers.

The countrywide agent and dealer network with 200 agents and 100 value added resellers provide proactive sales of the product and service portfolio of Matáv and its ISP subsidiary, Axelero in the residential and SME markets. The Matáv dealer network also provides tailor-made services and can offer complete telecommunications solutions (e.g. voice, data, PBX, router) to business customers. In 2003, the indirect sales channels reached remarkable results in data communications products and services (DSL, Flex-com, IP) sales.

The Matáv Pont retail network reaches all Matáv areas in Hungary and we have opened customer contact points in the LTO areas as well. Not only the Matáv services are available in the most important retail network of Matáv, but all services of the Matáv Group, including all types of Axelero Internet access, Westel mobile prepaid pricing plans and cable TV services of Matáv KábelTV.

Matáv served 1.3 million customers in 2003 through its retail shops. Customer satisfaction measured in Matáv Pont shops is highest within Matáv. Matáv also has 55 Matáv Pont Franchise Network that help in retail distribution.

TeleSales activity increased within retail sales channels and has the key role in the sales of several Matáv pricing plans. The revenue generated by this channel substantially increased in 2003.

The Internet store of Matáv, ePont, showed remarkable results in 2003. The number of visitors increased by 360 percent, and the number of service orders increased by 320 percent. These figures indicate that the customers show an increasing interest in using on-line product sales channels.

In the highly competitive SME segment Matáv T-LoB has launched a new sales channel focusing on sales projects. The target of the team is to empower the Company's sales efficiency in these markets or industrial micro segments where competition is higher, or more business opportunities could be profitably realized.

The pro-active approach has been commenced in four main fields:

residential parks' projects;

Audiotex/Audiofix sales for media production companies;

acquisitions in other service providers' markets; and

reacquisitioning already lost customers.

### **Competition**

Despite the high expectations related to market liberalization, the Hungarian telecommunications market did not see the development of intense competition. Even though alternative carriers emerged, Matáv managed to retain its leading role in the voice services market. The largest competitors, Pannon and Invitel (formerly known as Vivendi), operate in the mobile and fixed segments, respectively, lacking the potential to cover the entire telecommunications value chain and realize cross-segment synergies. Matáv is the only integrated service provider in the market.

***Domestic and International Fixed Line Telecommunications Services***

Until the end of 2002, the Company's fixed line operations were subject to indirect competition from mobile telecommunications providers. In addition, following full liberalization of fixed line voice telephony, a variety of market entrants providing public fixed voice telephony service, either by interconnecting with Matáv's network or via their own infrastructure, could begin to compete. Existing and potential service providers include other LTOs, operators of existing alternative networks, such as public utilities, railways and mobile telecommunications providers and global alliances of international telecommunications providers.

In 2003, the mobile carriers remained to be Matáv Rt.'s key competitors relating to domestic calls. LTOs and alternative service providers concentrate their offers on the business customers in the areas of long distance and international calls. Due to their less developed network and their lower margin Matáv could successfully keep its leading position in domestic telephony and had 78.6 percent market share in terms of access lines in Hungary as of December 31, 2003. Alternatives are present in the residential market as well with prepaid calling cards used for IP telephony, but Matáv currently faces strong competition in international long distance services.

In the geographic service areas of Matáv three carriers (Invitel, PanTel and BT) offered preselection and call-by-call services in 2003 and they were able to take some of Matáv's customers. Matáv also offers similar packages and is successful in attracting new customers from LTO areas. In 2004, with the introduction of number portability, competition will be even stronger. As customers will be allowed to retain their phone numbers, it will provide a good opportunity for Matáv to gain additional market share, but at the same time it will present a threat of losing existing customers.

***Leased Lines and Data Transmission Services***

In the continuously expanding Hungarian leased line and data transmission market, Matáv retained its leading role in 2003. Its key competitors are the alternative telecommunications carriers (GTS-Datanet, PanTel), that offer products and services primarily based on fixed line and microwave leased line technologies. The data transmission market also featured other, cheaper technologies, such as IP, driven by the technological development and by the possibility to replace leased lines with various DSL technologies.

The Internet market in Hungary is dominated by a few large ISPs, although several dozen Internet providers are registered in the market. In 2003, the main trend in the Internet market was the rapid growth of broadband services. The number of broadband Internet access increased by nearly 200 percent as compared to 2002 and at Axelero, every fifth Internet access is via ADSL. In the Internet market, Axelero, Matáv's fully owned subsidiary, is the market leader with an estimated 44 percent market share based on the number of dial-up subscribers. Its key competitors are the Internet affiliates of the alternative telecommunications service providers and UPC, the company offering broadband access via cable television.

***Mobile Telecommunications Services***

The Hungarian mobile telecommunications market is characterized by intense competition driven not just by new services and attractive prices, but marketing as well. In 2003, competition was stronger than ever in the mobile telecommunications market, which was characterized by new services, lower tariffs and aggressive marketing campaigns. The two competitors of Westel are Pannon and Vodafone in the Hungarian mobile communications market. Data transmission services and content services are playing an

increasingly important role in the carrier offerings. In 2003, the mobile penetration rate further increased, reaching 78.5 percent by the end of the year. Westel continues to be the largest service provider in the mobile telecommunications market. Despite aggressive competition, Westel could retain its market leading position with a 47.4 percent market share based on the number of subscriptions.

*International segment*

MakTel is the sole fixed line service provider in Macedonia. Its exclusive rights in fixed line telecommunications services will expire in December 2004. MobiMak was the sole mobile operator in Macedonia until June 2003, when Cosmofon entered the market. As of December 31, 2003, MobiMak had an estimated 86 percent market share in the mobile telecommunications market in Macedonia.

**Dependence on Patents, Licenses, Customers, Industrial, Commercial and Financial Contracts**

We do not believe that Matáv is dependent on any patent or other intellectual property right, on any individual third party customer or on any industrial, commercial or financial contract. Similar to other fixed line and mobile operators, Matáv requires telecommunications licenses from the governments of Hungary and Macedonia, the two countries in which it operates.



## REGULATION AND PRICING

### Development of the Telecommunications Regulatory Regime in Hungary

The regulatory regime governing telecommunications services in Hungary has been substantially revised since 1990, when the former state postal, telephone and telegraph authority, Magyar Posta, was divided into three distinct operations. Act LXXII of 1992 on Telecommunications, as amended (the "Telecommunications Act"), established the general regulatory framework for the Hungarian telecommunications sector. The Telecommunications Act provided for the promulgation of additional decrees by the Hungarian government and the Ministry. The concession telecommunications market was also governed by other legislation that is not specific to telecommunications, including, among others, Act XVI of 1991 on Concessions, as amended (the "Concessions Act"), Act LXXXVII of 1990 on Pricing, as amended (the "Pricing Act"), and Act LVII of 1996 on the Prohibition of Unfair and Restrictive Market Practice (the "Competition Act").

In 1993, the Minister divided Hungary into 54 local primary geographic areas ("Local Primary Areas") for local public fixed line voice telephony service. In August 1993, the Minister issued an international tender for the right to provide international and domestic long distance telephone services throughout Hungary and to provide local public fixed line voice telephony services in 29 of the 54 Local Primary Areas, including Budapest. The Minister selected MagyarCom, Matáv's parent holding company, as the winning bidder in the tender.

MagyarCom then assigned certain of its rights to Matáv. On December 22, 1993, Matáv entered into the Concession Contract with the Minister. The Concession Contract gave Matáv the exclusive right to provide domestic long distance and international public fixed line voice telephony services throughout Hungary and local public fixed line voice telephony services in 29 Local Primary Areas for a term of eight years ending December 22, 2001.

In September 1993, the Minister issued a second competitive tender for the exclusive right to provide local public fixed line voice telephony services in the remaining 25 of the 54 Local Primary Areas. Matáv obtained the right to provide services directly in seven of those areas by being the successful bidder in respect of five areas and the default provider in two areas where there was no successful bidder. Matáv also obtained the right to provide services indirectly in an additional three areas through joint ventures. With respect to the five areas where it was the successful bidder, Matáv's rights are governed by separate concession contracts. Rights to service the remaining 15 areas were distributed among 12 local telephone operators.

In 2000, the government disintegrated the Ministry of Transport, Telecommunications and Water Management in order to establish the Ministry of Transport and Water Management and the Telecommunications Government Commissioner's Office, which was a part of the Prime Minister's Office and bear sole responsibility for all matters related to telecommunications. The rights of the Prime Minister Office were transferred as of May 27, 2002 to the Ministry of Informatics and Communications.

The regulation of the Hungarian telecommunications market was fundamentally changed on December 23, 2001 when the Act on Communications came into force. The Act on Communications superseded the Telecommunications Act on December 23, 2001. The Act on Communications provided the main legal framework for the Hungarian liberalized telecommunications market until the end of 2003, and it provided for the promulgation of additional (governmental and ministerial) decrees.

On January 28, 2002, the Minister and Matáv concluded the Contract on Universal Service Provision. According to this contract, the national concession was terminated on January 31, 2002, while in the five

local areas (Debrecen, Nyíregyháza, Szentendre, Székesfehérvár and Szolnok) the local concessions terminated on May 24, 2002.

Limited amount of competition that resulted from the Act on Communications and harmonization of Hungarian law to EU standards required by the accession of Hungary to EU made the modification of the regulatory regime governing telecommunications sector necessary. Act C of 2003 on Electronic Communications, the latest regulations on the telecommunications sector, came into effect on January 1, 2004 and Act on Communications was superseded at the same time. In line with the authorization of Act C of 2003 on Electronic Communications, several executive decrees (government and ministry decrees) have been and will be issued as well.

#### **The Act on Electronic Communications and the Contract on Universal Service Provision**

Act on Electronic Communications was approved by the Parliament on November 24, 2003 and came into effect on January 1, 2004. The main goals of the new act are:

- to further improve the electronic communications infrastructure of the information society;
- to provide consumers with reliable and safe electronic communications services of proper quality at the lowest possible prices;
- to promote efficient competition in the electronic communications market regardless of the technology applied; and
- to comply with the legislation of the European Community.

Set forth below is a brief summary of certain provisions of the Act on Electronic Communications.

The Act on Electronic Communications has fundamentally changed the authority structure of the liberalized telecommunications market. The National Communications Authority ("NCA") is the supreme supervisory body.

The tasks of the NCA are:

- to facilitate the smooth and successful operation and development of the electronic telecommunications market;
- to protect the interests of the entities both performing and using electronic communications activities;
- to promote the establishment and maintenance of fair and efficient competition in the electronic communications industry; and
- to supervise compliance by the organizations and persons performing electronic communications activities with the provisions of the law.

The two organisational units of the NCA are the Board of the National Communications Authority ("Board") and the Office of the National Communications Authority ("Office"). The Board has seven members. The member to chair the Board is appointed by the Prime Minister for five years upon recommendation from the Minister. The Minister appoints the other six members of the Board for five years upon recommendation by a technical nominating body, constituted of members invited by the Minister.

The tasks of the Board are to:

perform the management of the NCA;

be responsible for the implementation of the provisions of legislation and government decisions concerning electronic communications;

make proposals for modifying electronic communications law;

stipulate the affected markets in accordance with the provisions of the Act;

identify market players with significant market power;

specify the obligations of market players with significant market power;

act if the rules of electronic communications are violated, and in the case of procedures initiated in connection with disputes concerning the execution of contracts; and

act in cases of price squeezing of network services.

The Office provides technical support to the Board and its members for the performance of the Board's functions. The Office acts in the name of the NCA concerning the matters specified in the Act on Electronic Communications, and handles the functions assigned to it by law or by the chairman of the Board.

Among others, the Office

oversees the designated inspection, verification and certification bodies;

acts as the technical authority for electronic communications;

handles the tasks concerning the management of the Universal Electronic Communications Support Fund as stipulated under the provisions of law;

performs other functions defined under the provisions of law;

is responsible for acting with regard to:

the notification of electronic communications services;

official matters concerning civilian frequency management;

the management of identifiers;

the maintenance of statutory records prescribed by law;

the elimination of interference;

market surveillance;

the utilization of real estate;

licensing electronic communications facilities; and

the supervision of construction works;

The NCA has a close cooperation with the Competition Office and the General Inspectorate for Consumer Protection. One member of the NCA is the representative of the consumer's rights in the telecommunications sector. He serves as the controller over the assertion of the consumers' rights. Beside the NCA, Permanent Court of Arbitration for Communications ("CAC") was also established.

*Universal Service.* According to the Act on Electronic Communications, universal services are basic communications services that should be available to all customers at an affordable price. Universal services include access to fixed line voice telephony services of regulated minimum quality enabling access to Internet services at a regulated minimum speed, a regulated density of public payphones, a public register of subscribers, national domestic inquiry service as well as cost-free call-barring and emergency calls. Access to voice services at an affordable price is guaranteed partly through the selection of universal service providers (the Minister shall appoint the most efficient service provider) and partly by introducing a subsidy granted to disabled or low-income users from the state budget. A ministerial decree is under construction to provide detailed instructions on procedure of the appointment.

According to Article 15 of Decree 29/1997 (XII. 20.) KHVM, the service provider is obliged to certify and attest that it meets the quality requirements set out in the obligatory standards described in separate laws, authority licenses and type certificates in addition to those standards that are undertaken in the business rules or contractual conditions of the company. Matáv Rt. was granted the certificate first on August 27, 2001 for its concession telephony services. During the autumn of 2002, Matáv Rt. had Mátrix Kft. to certify its universal and publicly available telecommunications services as well. The certifying organization issued the certificate on the Company's compliance on December 16, 2002. This certificate is valid until November 10, 2005 with ongoing reviews every six months. Matáv confirmed its qualifications on all audits. (A new separate ministerial decree will regulate the quality of universal services.)

Universal service providers are entitled to compensation for their net avoidable costs, except for the costs incurred from discount pricing plans offered to residential subscribers. A separate Ministerial Decree will determine the detailed rules applicable to calculate the net avoidable costs. The compensation will be available for universal service providers from the Universal Electronic Communications Support Fund.

Matáv became a universal service provider as a consequence of the universal service contract that had been concluded between Matáv and the Minister on January 28, 2002. Matáv's Fixed Lines Concession Contracts have been superseded by the Contract on Universal Service Provision, in such a way that the national concession (which included the international and domestic long distance as well as the local concessions) in 31 primary areas was terminated on January 31, 2002, while the local concessions in the remaining five concession areas were terminated on May 24, 2002. In the Contract on Universal Service Provision the Minister acknowledged that Matáv Rt. fully complied with all of its obligations during the concession period.

The concession fee was duly paid by the Company regarding the first month of 2002 for the nationwide concession and regarding the period until May 24 for the five primary areas. The Minister has no outstanding claims against the Company. Upon the termination of its concession contract in its three primary areas on November 1, 2002, Matáv's subsidiary, Emitel also concluded the contract on universal service provision with the Minister.

Based on the new regulation included in the Act on Electronic Communications applying to universal services, the Minister of Communications can appoint the most efficient bidder(s) as universal service provider(s). Matáv expects to continue providing universal services at its present service area. In this case Matáv's universal service contract will have to be modified by July 1, 2004.

*Subscriber Contracts.* The service providers must prepare both general terms and conditions and subscriber contracts to be entered into with the subscribers. The Act on Electronic Communications contains the general rules of agreements between subscribers and telecommunications service providers for telecommunications services. The ministerial Decree 16/2003 (XII.27.) on "Telecommunications Subscriber Contract" contains other important rules of subscribers' contracts. In the subscriber contract, the parties can rephrase the provisions of the Act on Electronic Communications only if they are more

favorable to the subscribers. The service providers already operating in the market were obliged to amend their existing general terms and conditions and subscribers contracts in accordance with the Act on Electronic Communications and ministerial Decree 16/2003 (XII.27.)

The general terms and conditions must contain, among other things, the process of concluding and amending subscribers contracts, the quality of the telecommunications service, the conditions for restriction of the service, the fault-repair service and the method for handling subscriber complaints. The individual subscriber contract must contain the personal data of the subscriber.

*Significant Market Power Regulation.* According to the Act on Electronic Communications all service providers that were designated as an SMP in 2003 remain to be SMPs in the interim period until the first market analysis and SMP designation to be performed under the EU standards, which are required to take place by September 1, 2004. These service providers are required to comply with regulations prescribed for the interim period by the Act on Electronic Communications and the related executive decrees. Until the end of the interim period the Board will determine the markets, analyze these markets, designate the SMPs on each market and impose certain obligations on each SMP. Obligations of SMP operators may include transparency, equal treatment, accounting separation, publishing reference offers for interconnection, access and bundling services (which must be offered on cost-based prices). Matáv has been designated as an SMP on the telephony and leased lines market by the regulator at the end of 2003. In the first quarter of 2004, the NCA requested the service providers to provide extensive operating data for market assessment and identification of operators to be given an SMP status. Although Matáv is submitting the requested information in several phases, the Company considers that this request had no legal basis and initiated a court procedure to challenge this request.

*Retail Prices.* According to the Act on Electronic Communications, the Minister acting in agreement with the Minister of Finance is responsible for regulating maximum tariffs for universal services. Tariff regulation in Hungary is currently based on the price-cap method.

Matáv's regulated access prices currently include an access deficit, i.e., Matáv's subscription fees do not cover the costs of access. According to the Pricing Act and the relating ministerial decrees (3/2002 (I.21.) MeHVM and 4/2002 (I.26.) MeHVM), the access deficit should be eliminated. Decree 3/2002 (I.21.) MeHVM deals with the access deficit problem by allowing an annual increase in subscription fees of universal pricing plans above annual inflation rate.

*Local Loop and Bit-stream Unbundling.* According to the Act on Electronic Communications and Government Decree 277/2003. (XII.24) on "The detailed rules of procedures related to the reference offers and networking contracts", designated SMP operators in the relevant market of the unbundled access or broadband access are obliged to unbundle local loops and prepare reference offers for unbundled local loops (whether fully or partially unbundled) and bit-stream access and to provide these services when there is a request for them by other telecommunications service providers.

The SMPs may refuse the offer for unbundling if:

there are technical barriers; and

providing access to the local loop or bit-stream access would endanger the unity of the SMPs' network.

An SMP does not have to grant access to the local loops if any of the subscribers who have entered a pre-agreement with the intended new service provider has outstanding debts towards the SMP on the date on which it would be obliged to grant physical access.

The cost base for the price of these services has to be calculated using Fully Distributed Costs ("FDC"). Fully Allocated Costs ("FAC") methodology could be used until December 31, 2002, then LRIC

was applicable until December 31, 2003. Requirements for the costing of these services are determined by Ministerial Decree 18/2003 (XII.27.).

The SMPs must prepare reference offer for the unbundling of the local loops and bit-stream unbundling in which they must regulate those matters listed in the Government Decree 277/2003 (XII.24.). The reference offer forms the basis of the agreements to be concluded with other service providers. The reference offer of each SMP must be approved by the Board, which keeps a public, open register.

*Interconnection.* According to the Act on Electronic Communications and Government Decree 277/2003 (XII. 24), SMPs are obliged to prepare reference offers for interconnection and to provide these services upon the reference offer when there is a request for them by other telecommunications service providers.

According to the Government Decree 277/2003 (XII. 24), the SMPs are obliged to enter into agreements for access to their networks on the basis of an offer put forward by another service provider. If the provider is obliged to prepare a reference interconnection offer, such as Matáv, this offer must be in line with the reference offer. The NCA has the competence to arbitrate in dispute cases and may establish provisional arrangements between the parties. The reference offer of the SMPs must be approved by the NCA.

*Carrier Selection.* According to the Act on Electronic Communications voice telephony customers have the right to select different service providers for each call directions including Internet calls by dialing a pre-selected number or by using a call-by-call pre-fixed number. The requirements for carrier selection are an interconnection agreement between the affected service providers, a carrier selection number and the connection of the calls to the desired end user. Detailed regulation was released in Government Decree 73/2004 (IV. 15) in April 2004.

*Number Portability.* Fixed line telecommunications service providers are obliged under the law to provide number portability on their networks starting January 1, 2004, and to allow subscribers to change service providers without changing their telephone numbers in the same geographic location. In addition, starting May 1, 2004, non-geographic and mobile number portability have been implemented. Details are regulated in Government Decree 46/2004. (III.18.) Regulations and technical solution for the geographic number portability (query on release based on a central database) are in line with the EU standards. Ministerial Decree 10/2004 (IV.22.) regulating the co-operation between the Central Reference Database and the service providers came into effect on May 1, 2004. As declared in the regulation, in case of geographic relocation the number can be retained upon request of the customer.

*Telecommunications Service Licensing Requirements.* According to the Act on Electronic Communications, the provision of communications services shall be notified to the Communications Regional Office for registration 30 days before service commencement.

All communications service providers that have obtained the right to provide communications services pursuant to license or notification before the Act on Electronic Communications entered into force may pursue such activity according to such right.

*Licensing and Allocation of Frequencies.* With the exception of a program receiver device, radio equipment, radio stations and radio communication networks may be operated with a radio license. A radio license may be issued exclusively on the basis of a valid frequency assignment license, with the exception of cases specified by law. Radio equipment, radio stations, radio networks and radio communications systems may be installed with a frequency assignment license, with the exception of cases specified by law. A regular fee specified by law shall be paid for the reservation and authorized use of the frequencies assigned for civil purposes, reservation of identifiers and use of the assigned identifiers.

Matáv Rt. pays a frequency license fee on the basis of Decree 6/1997 (IV.22) KHVM on "Frequency Reservation and Usage Fee" and Government Decree 120/1998 (VI.17.) on "Rules of Payment of Frequency Reservation and Usage Fee". Additional rules applying to Matáv include Government Decree 284/2002 (XII.21.) on "Specification of the National Frequency Allocation Table" and Government Decree 11/2003 (I.30.) on "Rules of the Auction and Tender to Obtain the Frequency Usage License".

Matáv Rt. pays a number usage fee for those call numbers that are used by the Company, according to Decree 19/2001 (X.31.) MeHVM on "Fees of Engaging the Number and Address Fields Necessary for the Provision of Public Telephony Services".

Frequency assignments must conform to the National Frequency Range Distribution Chart, which lays out the entire spectrum and the purpose and availability of frequency bands. Matáv's frequencies are generally valid for periods of one to five years. The frequency assignment for the Radio Local Loop system ("RLL") was valid through November 2003. According to the contract concluded with the Ministry on November 4, 2003, Matáv has already finished the replacement of RLLs.

If a telecommunications service provider wishes to provide services that require a frequency assignment and appropriate frequencies are available, the NCA must hold a public auction or drawing. A public auction is held if the number of available frequencies is not sufficient to satisfy all requests. A drawing is held if the number of available frequencies is sufficient to satisfy requests but the frequencies have differing qualitative characteristics.

The state announced a tender for the 3.5 GHz frequency, where Matáv's bid was among the winners. The frequency is used for the provision of new telecommunications services.

*Rights of Way.* According to the Act on Electronic Communications, communications service providers are entitled upon prior notification of the owner to install telecommunications equipment on private property and to enter private property where communications facilities (equipment, cables, antennas) are located for maintenance and fault elimination purposes. The public telecommunications service provider has to enter into a contract with the property owner setting forth the conditions for the common use of the property. Owners of real property are also obliged to remove obstructions to public telecommunications networks. Owners of real property have the right to claim compensation for the nuisance suffered as a result of entry onto their property.

Upon request, the competent inspectorate could establish easements in favor of a public telecommunications service provider on real property for the purposes of placing communications facilities. Matáv is seeking easements over a substantial number of real properties on which the Company or its predecessors installed such facilities. If the placement of telecommunications equipment prevents or materially hinders use of real property, the owner may request the purchase or expropriation of the property after seeking an opinion from the Inspectorate. The party that orders construction (installation) of communications structures shall restore the initial conditions of the environment after the completion of construction works. If the communications structure installed by the service provider provides for the customer residing or staying in the direct proximity of the structure better than average service or additional services, the service provider may not require compensation for it, neither in the subscriber contracts nor in any other way.

#### **Mobile Concession Contracts**

Hungary was the first country in Central and Eastern Europe to introduce public mobile telecommunications services. Westel 0660 began providing analog mobile radiotelephone service in



October 1990 with an exclusive license and in 1994 entered into an exclusive concession contract with the Minister. In 1993, the Minister awarded two concessions to provide nationwide cellular telephone services using the digital GSM 900 standard: one to Westel and the other to Pannon.

In March 2000, Deutsche Telekom finalized the purchase of MediaOne's interests in mobile operations in Central and Eastern Europe including MediaOne International B.V. which owned 49 percent of Westel and 49 percent of Westel 0660. At the same time the Company was granted an option to purchase the 49 percent holdings in Westel and Westel 0660 from Deutsche Telekom during the fifteen-month period ending September 2001. On December 21, 2001 the Company became a 100 percent owner of both Westel and Westel 0660. The final purchase price included HUF 226,750 million (EUR 920 million), paid in December 2001, financed by a loan from DT, plus HUF 11,515 million paid in 2002, equal to 49 percent of the amount of dividends declared by Westel for the year 2001.

#### **Westel**

Under the Concession Contract, dated November 4, 1993, as amended (the "900 Concession Contract"), between the Minister and Westel, Westel has the right for 15 years from that date to provide public GSM mobile telephony services. Westel is authorized to provide GSM service in the 906 to 914 and 951 to 959 MHz frequency ranges in Hungary.

The parties may agree to extend the Westel concession for a period of seven and one-half years.

On February 25, 1999, the Ministry issued an invitation to tender for the licensing in Hungary of DCS 1800 services, a mobile telecommunications system operating in the 1800 MHz frequency band. The tender was closed on May 7, 1999. On October 7, 1999 an amended 900 Concession Contract was signed, allowing Westel and its GSM 900 competitor, Pannon, to start commercial service in the 1800 MHz band for 15 years beginning November 26, 2000. At that time the Minister also signed a concession contract with V.R.A.M. Rt., the new entrant on the Hungarian digital cellular market, which uses the Vodafone brand name.

Westel, simultaneously with Pannon, started commercial operation in the 1800 MHz band on November 16, 2000. Upon request by Vodafone, the national roaming agreement between Westel and Vodafone was terminated effective November 30, 2000, whereby Westel was released from the obligation to provide Vodafone with domestic roaming services on a nationwide basis. Effective December 6, 2002 Pannon terminated its national roaming agreement with Vodafone. As Vodafone had no remedy available against such a unilateral decision, it was forced to speed up its network roll-out campaign to close the coverage gap vis-a-vis its competitors.

By virtue of the amendment to the Concession Contract in 1999, by the end of 2003, the three digital mobile telecommunications service providers should have had the same spectrum resources allocated to them both on the 900 and the 1800 MHz bands. This condition has not been met, but the Ministry has taken steps to remedy the situation.

Westel was required to pay a HUF 11 billion concession fee, adjusted for changes in the HUF/USD exchange rate. The first installment of the concession fee, HUF 2,750 million was paid eight days after the modification of the 900 Concession Contract (November 1999). The second installment of HUF 2,750 million, adjusted for changes in the HUF/USD exchange rate, was paid eight days after the commencement of 1800 MHz service (November 16, 2000). The third installment of HUF 1,830 million, adjusted for the changes in the HUF/USD exchange rate, was paid on November 30, 2002. The last installment of the concession fee, HUF 3,670 million, adjusted for the changes in the HUF/USD exchange

rate was paid on December 31, 2003. Westel also pays an annual concession fee of USD one million since the commencement of the 1800 MHz service.

*Frequency Fees.* In accordance with the 900 Concession Contract, the frequency fee payable to the Ministry consists of two parts: a frequency reservation fee and a frequency usage fee. Westel must pay the Hungarian government a frequency reservation fee of HUF 256 million per year for the nationwide reservation of one 8 MHz duplex frequency band (40 GSM duplex radio channel) in respect of the 900 MHz frequency band. This fee decreases in proportion to the percentage of the nationwide coverage of the service. Westel must also pay a frequency usage fee of HUF 200,000 per year for each GSM duplex channel and base station with a radio license. Pursuant to a new regulatory decree passed in December 2002, the former payment obligation, in respect of the frequency reservation fee, has been revoked. Westel also had frequency fee payment obligations for channels allocated in the 1800 MHz band. In 2003, based on a fairly complex calculation methodology set out in the Concession Contract, Westel paid HUF 90 million for the right to use the 9 MHz frequency band, plus HUF 130 million for the actual use of channels within that band. Both amounts were adjusted for the changes in the HUF/USD exchange rate. In total, in 2003, Westel paid a HUF 2,978 million frequency usage fee for all frequency usage in both the 900 and the 1800 MHz bands, adjusted for the changes in the HUF/USD exchange rate.

*Tariffs.* Commencing January 1, 1998, Westel's subscriber charges ceased to be regulated under the Pricing Act or ministerial decree and consequently ceased to be subject to the previously applicable price-cap regime.

*Roaming Agreements.* Westel may sign roaming agreements with other public mobile telecommunications service operators outside of Hungary in accordance with the rules of the GSM Association, an association of GSM operators and associated members.

*Interconnection.* If Westel receives a request for interconnection (to provide either network access or network interconnection) from another telecommunications operator, it is required under the Act on Electronic Communications and Government Decree 277/2003 (XII.24.) to enter into a contract, provided that such request is justified on both technical and economic grounds and the meeting of such request is not rendered impossible due to a scarce resource. Under the new regulatory regime, in accordance with the EU New Regulatory Framework, the obligation is imposed not by the law, but through the decision of the regulatory authority.

In November 2002, the CAC designated Westel as having SMP in the relevant market of national interconnection. Westel, per statutory obligations, filed its cost calculation methodology and relevant cost/tariff data based on the mandatory LRIC model, as provided for by the law. Pannon was also designated by the CAC as having SMP in the same relevant market, but it chose to appeal the decision and refused to submit its cost data and LRIC model. In order to avoid a competitive disadvantage and to seek non-discriminatory treatment, Westel filed an official request with the CAC for a temporary staying order for the execution of the decision regarding the implementation of its SMP obligations until the final settlement of the judicial review initiated by Pannon.

The court of first instance put a staying order on the execution of the SMP decision with respect to Pannon but this order was appealed successfully by the CAC. Pannon appealed that decision and the Supreme Court required the court of first instance to start a new proceeding, which is currently in progress. Westel intervened in the case on the side of the NRA.

Westel was obligated to decrease its fixed-to-mobile termination charges by 10 percent, effective September 1, 2003, while Pannon was not under the same legal obligation, due to the decision of the court of first instance. This resulted in an asymmetrical situation as regards call termination charges. However, Pannon later chose to follow Westel on its own initiative and introduced a lower, five percent decrease in

its mobile termination charges, effective October 1, 2003. Westel challenged in court the decision of the CAC setting out the obligation to decrease its interconnection tariffs.

In November 2003, the Supreme Court upheld the decision of the CAC in the Pannon case and ordered the telecommunications authority to re-launch the entire market analysis and SMP-designation procedure. As a result of this new proceeding closed in November 2003, both Westel and Pannon have been again designated as an SMP in the national interconnection market. Pannon challenged that decision in court and Westel has intervened in the case on the side of the CAC. Pursuant to the decision, Westel filed its LRIC model and the associated cost, while Pannon failed, in the first instance, to do so. As a consequence, the CAC imposed a significant fine on Pannon. Notwithstanding the fact that Pannon sought a judiciary review of this decision, it submitted subsequently its LRIC model and cost data.

*Market assessment and SMP designation process.* Pursuant to the provisions of the Act on Electronic Communications, the regulator launched, by issuing an order in March 2004, a new market assessment and analysis procedure with the aim of identifying operators having an SMP status in the defined markets. Westel submitted the required information by the April 5, 2004 deadline, however its response does not include certain data that Westel considered irrelevant for the purpose of market assessment or being excessive for the regulatory goal. The NCA is expected to complete the market analysis by September 2004 and advise the EU Commission of the proposed remedies to be applicable to the operators with SMP status. In line with the EU principles, it is expected that all three GSM mobile operators in Hungary will be identified operators with SMP status in the national interconnection market and will likely to be subject to the same regulatory obligations thereafter.

*Domestic Goods and Services.* Westel must use specified percentages of Hungarian goods and services. Westel currently satisfies these requirement