HUNGARIAN TELEPHONE & CABLE CORP
Form 10-K
March 19, 2007
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United States

Securities and Exchange Commission

Washington, DC 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

OR

¨ **TRANSITIONAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission File Number 1-11484

HUNGARIAN TELEPHONE AND CABLE CORP.

(Exact Name of Registrant as specified in its charter)

Delaware	**13-3652685**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1201 Third Avenue, Suite 3400, Seattle, WA 98101-3034

(Address of Principal Executive Offices) (Zip Code)

Registrant s telephone number, including area code: (206) 654-0204

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value $.001 per share	American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 requirement for the past 90 days. Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated Filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of March 12, 2007, 12,888,171 shares of the registrant s Common Stock were outstanding, of which 4,672,782 were held by non-affiliates of the registrant. The aggregate market value of the registrant s Common Stock held by nonaffiliates, computed by reference to the closing price of the Common Stock on the American Stock Exchange as of the last business day of the registrant s most recently completed second fiscal quarter was $70.1 million. The exclusion of shares owned by any person from such amount shall not be deemed an admission by the registrant that such person is an affiliate of the registrant.

Documents Incorporated by Reference

Part III - Portions of the Registrant s proxy statement for its 2007 Annual Meeting of Stockholders.

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Glossary of Terms

Our industry uses many terms and acronyms that may not be familiar to you. To assist you in reading this document, we have provided below definitions of some of these terms.

Access Lines. Telephone lines reaching from the customer s premises to a connection with the telephone service provider s network. When we refer to our access lines, we include our customers with either a wired or fixed wireless connection to our network.

Access Network. The part of the telecommunications network which connects the end users to the backbone.

Average Revenue Per User (ARPU). The average revenue per user.

Asynchronous Transfer Mode (ATM). A broadband, network transport service that provides a fast, efficient way to move large quantities of information.

Backbone. A centralized high-speed network that interconnects smaller, independent networks.

Bandwidth. The number of bits of information which can move through a communications medium in a given amount of time (normally measured in bits per second).

Broadband. High speed access to the Internet. Telecommunication in which a wide band of frequencies is available to transmit information. Because a wide band of frequencies is available, information can be multiplexed and sent on many different frequencies or channels within the band concurrently, allowing more information to be transmitted in a given amount of time. Various definers have assigned a minimum data rate to qualify as broadband.

Carrier Selection (CS). The ability to select the telecommunications service provider for certain calls on a call-by-call basis, whereby a telecommunications service provider different from the default telecommunications service provider may be selected by the customer by dialing a prefix when making certain calls.

Carrier Pre-Selection (CPS). The ability to select the telecommunications service provider for certain calls on a pre-set basis so that the selected telecommunications service provider is the default telecommunications service provider on such calls without having to dial a prefix.

Central Office (CO). The site with the local telecommunications provider s equipment that routes calls to and from customers. It also connects customers to Internet Service Providers and long distance carriers.

Churn. It represents the percentage of customers that disconnect or are terminated from service relative to the customer base.

Dark Fiber. Unused fiber optic cable. Fiber optic cables convey information in the form of light pulses so that dark fiber means that no light pulses are being sent over the fiber optic cable.

Dense Wavelength Division Mulitplexing (DWDM). A way of increasing the capacity of fiber optic networks. DWDM carries multiple colors of light, or multiple wavelengths on a single strand of fiber.

Digital Enhanced Cordless Telecommunications (DECT). A wireless standard based on time division multiple access technology used for wireless local loop systems.

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Digital. A method of storing, processing and transmitting information through the use of distinct electronic or optical pulses that represent the binary digits 0 and 1. Digital transmission and switching technologies employ a sequence of these pulses to represent information as opposed to the continuously variable analog signal. The precise digital numbers minimize distortion (such as graininess or snow in the case of video transmission, or static or other background distortion in the case of audio transmission).

Digital Subscriber Line (DSL). A technology for providing high-speed data communications over copper telephone lines.

Ethernet. A local area network architecture. It is the most common type of connection computers use in a local area network. An Ethernet port looks much like a regular phone jack, but is slightly wider. This port can be used to connect a computer to another computer, a local network, or an external DSL or cable modem.

Fiber Optic Cable. A type of cable made from hair-thin glass (rather than copper) through which information travels as light. Fiber optic cables have a much greater bandwidth capacity than metal cables. Fiber optic cables form the basis for telecommunication providers backbone networks in transmitting information long distances.

Firewall. A system that acts as an interface between two networks and regulates traffic between those networks for the purpose of protecting the internal network from electronic attacks originating from the external network. Normally a firewall is deployed between a trusted, protected private network and a public network. For example, the trusted network might be a corporate network and the public network might be the Internet.

Fixed Lines/Fixed Telephone Lines. Refers to both wireline and fixed wireless telephone access lines.

Fixed Wireless. The operation of wireless devices (such as a telephone) in fixed locations such as homes and offices. The geographic range of the mobility is limited to a small area.

Frame Relay. A high speed switching technology, primarily used to interconnect multiple local area networks.

Incumbent Local Telephone Operator (ILTO). A traditional wireline telecommunications service provider that, prior to the end of 2002, had the exclusive right and responsibility for providing local telecommunications services in certain local service areas within Hungary.

Integrated Services Digital Network (ISDN). A telecommunications standard that uses digital transmission technology to support voice, video and data communication applications over regular telephone lines.

Internet Protocol (IP). A protocol for transferring information across the Internet in packets of data.

Internet Service Providers (ISPs). Businesses that provide Internet access to customers.

Last Mile. The telecommunications technology that connects the customer s premises directly to the network of the telecommunications provider, traditionally a wired connection through a twisted pair copper wire telephone cable (in the case of the telecommunications provider) or a coaxial cable (in the case of a cable television operator) but it can also be a fixed wireless connection.

Local Area Network (LAN). A network located in a single location such as a floor, department or building.

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Local Loop. The telephone line that runs from the local telephone company s equipment to the end user s premise. The local loop can be made up of fiber, copper or wireless media. It usually refers to the wired connection from a telephone company s central office in a local area to its customer s premises.

Local Loop Unbundling. The process of making the local loop available to the local loop owner s competitors.

Metropolitan Area Network (MAN). A network that covers a metropolitan area such as a portion of a city. The area is larger than that covered by a local area network but smaller than the area covered by a wide area network.

Multiplexing. The combination of multiple analog or digital signals for transmission over a single line.

Network. An arrangement of data devices that can communicate with each other such as the telephone network over which telephones and modems communicate with each other.

Point of Presence (POP). The physical location where the line from a long distance carrier or the server of an Internet Service Provider connects to the line of the local telecommunications service provider (usually at the local telephone company s central office).

Point to Multipoint (PMP). Refers to the use of microwave technology to link the telecommunications service provider s point-of-presence with a number of remote customer locations.

Point to Point (PP). Refers to the use of microwave technology to link the telecommunications service provider s point-of-presence directly with one single customer location.

Private Branch Exchange (PBX). Computerized on-site telephone systems located within an organization s premises. They route calls both within an organization and from the outside world to people within the organization.

Private Lines or Dedicated Lines or Leased Lines. A telephone line (a direct circuit or channel) specifically dedicated to an end-user organization for the purpose of directly connecting two or more of that organization s sites. They are used to transmit voice, data or video between the sites.

Synchronous Digital Hierarchy (SDH). The international standard for synchronous data transmission over fiber optic cables. The North American equivalent of SDH in SONET.

Transit Services. An interconnection service whereby a carrier provides transportation services for information (voice, data and video) by linking two networks that are not directly interconnected.

Universal Mobile Telecommunications System (UMTS). A third generation (3G) wireless system designed to provide a wide range of voice, high speed data and multimedia services.

Unbundled Network Elements (UNEs). The discrete elements of a telecommunications service provider s network that are sold or leased to competing telecommunications service providers, which elements may be combined to enable that competitor to provide retail telecommunications services.

Virtual Private Network (VPN). A private network that operates securely within a public network (such as the Internet) by means of encrypting transmissions. It provides the functions and features of a private network without the need for dedicated private lines between different end-user organization s sites. Each end-user organization s site connects to the network provider s network rather than directly to the end-user s other sites.

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Voice over Internet Protocol (VoIP). The transmission of voice using Internet-based technology over a broadband connection rather than a traditional wire and switch-based telephone network.

Web Hosting. The business of providing server space, storage, Web services and file maintenance for Web sites controlled by individuals or businesses that do not have their own Web servers.

Wide Area Network (WAN). A geographically dispersed network that is housed in more than one location. Its area is larger than that covered by metropolitan area network.

Wireless Local Loop. A wireless connection between the customer s premises and the telephone company s central office.

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PART I

In this Form 10-K, all references to $, USD or U.S. dollars are to United States dollars, all references to , EUR or euros are to the euro v the currency of the European Monetary Union, all references to HUF or forints are to Hungarian forints which is the currency of the Republic of Hungary, and all references to DKK are to Danish kroner which is the currency of Denmark. Certain amounts stated in euros, forints and kroner herein have been also stated in U.S. dollars solely for the informational purposes of the reader, and should not be construed as a representation that such euro, forint or krone amounts actually represent such U.S. dollar amounts or could be, or could have been, converted into U.S. dollars at the rate indicated or at any other rate. Unless otherwise stated or the context otherwise requires, such amounts have been stated at December 31, 2006 exchange rates. As of December 31, 2006, the euro/U.S. dollar middle exchange rate was approximately 0.758 euros per U.S. dollar, the forint/U.S. dollar middle exchange rate was approximately 191.62 forints per U.S. dollar and the krone/U.S. dollar middle exchange rate was approximately 5.65 kroner per U.S. dollar.

Unless the context requires otherwise, references in this report to the Company, we, us and our refer to Hungarian Telephone and Cable Corp. and its consolidated subsidiaries.

Item 1. Business.

Company Overview

Hungarian Telephone and Cable Corp. (HTCC or the Registrant) was incorporated in Delaware in 1992 as a holding company to acquire concessions from the government of the Republic of Hungary to own and operate local wireline telephone networks in Hungary as Hungary privatized its telecommunications industry. We have provided basic local wireline telephone services as the incumbent provider within three defined regions of Hungary since 1996 and long distance services to our customer base in these three defined regions since 2002. Our regions cover 668,000 people, representing approximately 7% of Hungary's population. We operate that business primarily through our Hungarian subsidiary, Hungarotel Tavkozlesi Zrt. (Hungarotel). Hungarotel is also a broadband and dial-up Internet Services Provider.

In order to expand our business in Hungary and the surrounding countries, we acquired PanTel Tavkozlesi Kft., a Hungarian company (PanTel). We purchased an initial 25% interest in PanTel in November 2004 and acquired the remaining 75% from Royal KPN NV, the Dutch telecommunications provider (KPN), in February 2005. PanTel is one of Hungary s leading alternative telecommunications providers with a nation-wide fiber optic backbone telecommunications network linking every county in Hungary. PanTel provides voice, data and Internet services to businesses throughout Hungary in competition with other telecommunications service providers including Magyar Telekom Nyrt. (the formerly State-controlled monopoly telephone company, Magyar Telekom") and Invitel Tavkozlesi Szolgaltato Zrt. (Invitel). PanTel provides, through another one of our subsidiaries PanTel Technocom Kft., telecommunications services to MOL (the Hungarian oil company) and operates and maintains various parts of MOL s telecommunications network. PanTel also uses its network capacity to transport voice, data and Internet traffic on a wholesale basis for other telecommunications service providers and Internet Service Providers in Hungary. PanTel s network crosses Hungary s borders and, using a combination of owned and leased capacity, extends PanTel s wholesale services into other countries of the Central and Eastern European region including Austria, Bosnia & Herzegovina, Bulgaria, Croatia, the Czech Republic, Macedonia, Romania, Serbia, Slovakia, Slovenia, Turkey and Ukraine. To service its customers global telecommunications needs, PanTel has interconnection agreements with several major international telecommunications service providers, which provide for interconnection at major international telecommunications hubs, including hubs in Frankfurt, London and Vienna.

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Our strategy is currently focused on three key markets: the Mass Market; the Corporate Market; and the Wholesale Market.

The Mass Market consists of Hungarian residential and small office/home office (SoHo) customers, both inside Hungarotel s three defined regions (in-concession) and outside Hungarotel s three defined regions (out-of-concession). At the end of 2006, Hungarotel had approximately 125,000 telephone lines connected to its network to service its in-concession Mass Market customers. At the end of 2006, PanTel serviced approximately 44,000 telephone lines in the out-of-concession Mass Market through carrier selection, carrier pre-selection and local loop unbundling services.

The Corporate Market consists of Hungary s large and medium-sized businesses and other institutional customers. At the end of 2006, PanTel had approximately 59,000 telephone lines in service in the Corporate Market, including approximately 7,000 carrier pre-selection telephone lines.

The Wholesale Market consists of other telecommunications service providers and Internet Service Providers in Hungary (Domestic Wholesale) and outside Hungary (International Wholesale) for whom PanTel transports voice, data and Internet traffic on a wholesale basis.

Substantially all of our assets are located in the Republic of Hungary. During 2006, 2005 and 2004, 72%, 74% and 100%, respectively, of our total revenue was derived from Hungary with the remaining revenue derived primarily from various countries in Central and Eastern Europe.

On January 8, 2007, we entered into a Stock Purchase Agreement with Invitel Holdings N.V. to indirectly acquire 99.98% of the outstanding shares of Invitel. The total consideration for the acquisition, including the assumption of net indebtedness on closing, is 470 million (approximately $620 million) and will be comprised of new borrowings and the issuance of up to 1.1 million shares of our Common Stock (representing approximately 6.2% our outstanding Common Stock on a fully diluted basis) to certain members of Invitel s current executive management team. The closing of the acquisition is subject to the satisfaction of customary closing conditions, including receipt of Hungarian and Romanian regulatory approvals, and is expected to close in the first half of 2007.

Invitel is the second largest wireline telecommunications service provider in Hungary. It is the incumbent provider in nine defined regions within Hungary, which cover 1.4 million people, representing approximately 14% of Hungary's population. At the end of 2006, Invitel had approximately 348,000 telephone lines connected to its network to service its in-concession Mass Market (316,000 telephone lines) and Corporate (32,000 telephone lines) customers. Like us, Invitel has expanded beyond its historical operating areas and now provides voice, data and Internet services in the remainder of Hungary. Invitel had 185.6 million (approximately $245 million) in revenue in 2006.

The Hungarian Operating Subsidiaries; the Parent Company

Hungarotel

We acquired the concession rights for local wireline telephone services in three defined regions from the Hungarian government for $11.5 million (at historical exchange rates) and purchased the existing telecommunications infrastructure, including 61,400 telephone access lines, from Magyar Telekom in 1995 and 1996 for $23.2 million (at historical exchange rates). The acquired telecommunications infrastructure was somewhat antiquated (manual exchanges and analog lines). We overhauled the existing infrastructure with a major capital expenditures program ($217 million through 2006 (at historical exchange rates)). The results of this investment are expanded and modern telecommunications networks in the three operating regions (Bekes, Nograd and Papa/Sarvar, each

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a Hungarotel Operating Area and together, the Hungarotel Operating Areas) deploying Siemens and Ericsson technology. Hungarotel was able to provide telephone service to customers who had waited years (in some cases, for over 20 years) for telephone service and offer modern telecommunications services beyond traditional voice service to all of its customers.

Hungarotel now owns and operates virtually all existing public telephone exchanges and local loop telecommunications network facilities in the Hungarotel Operating Areas and was, until the expiration of its exclusivity rights in 2002, the sole provider of non-cellular local voice telephone services in such areas. Hungarotel s networks have the capacity, with only normal additional capital expenditures required, to provide basic telephone services to virtually all of the estimated 279,600 residences and 38,500 business and other institutional customers (including government institutions) within the Hungarotel Operating Areas.

While Hungarotel had a government-protected monopoly on local wireline voice telephone services in the Hungarotel Operating Areas through 2002, Magyar Telekom was the sole provider of domestic and international long distance wireline voice telephone services through 2001 under a government-protected monopoly. Hungarotel had to transfer all of its long distance voice traffic to Magyar Telekom for completion. When Magyar Telekom s monopoly expired, Hungarotel became the sole long distance carrier for its customer base beginning in 2002. Since we did not have our own nation-wide long distance network or an international network, international calls and certain domestic long distance calls initiated in the Hungarotel Operating Areas by our customers had to be transferred to another telecommunications carrier for transmission to the local telecommunications network of the party receiving the call. Competition in the Hungarotel Operating Areas for wireline services effectively began in 2004. With carrier selection, unbundling obligations and number portability now fully implemented in the Hungarian telecommunications marketplace, Hungarotel is subject to intense competition in its home markets. See -Summary of the Communications Act-Significant Market Power.

In addition to local, domestic long distance, and international voice services, Hungarotel offers its customers data transmission and other value-added services, including broadband DSL Internet access and services, dial-up Internet access and services, voice mail, Internet Protocol-based voice services for international calls, leased line services, caller ID, call waiting, call forwarding, three-way calling, toll free calling services and audio text services.

The following table sets forth certain information as of December 31, 2006 with respect to each of the Hungarotel Operating Areas.

Area	Bekes	Nograd	Papa/Sarvar	Total
Population	391,700	147,900	128,400	668,000
Residences	166,900	62,400	50,300	279,600
Businesses (1)	23,100	8,900	6,500	38,500
Access Lines:				
Residential	59,400	25,700	27,300	112,400
Business (2)	14,500	6,000	5,200	25,700
Total	73,900	31,700	32,500	138,100
Pay phones	695	334	294	1,323
Population Penetration (3)	18.9	21.4	25.3	20.7
Residential Penetration (4)	35.6	41.2	54.3	40.2

(1) Represents Company estimates of business and other institutional customers or potential customers (including government institutions).
(2) Represents Company estimates of customers which are businesses and other institutional customers (including government institutions), leased lines and pay phones. Includes ISDN equivalent lines. Approximately 13,000 of the business customers are in the Corporate Market and serviced by PanTel.

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(3) Population Penetration rate is defined as the number of access lines per 100 inhabitants.
(4) Residential Penetration rate is defined as the number of residential access lines per 100 residences.
The following map shows the location within Hungary of the Hungarotel Operating Areas.

PanTel

PanTel was founded in 1998 by KPN, MAV Rt. (MAV, the Hungarian state railroad company) and KFKI Investment Ltd. (a Hungarian entity) to compete with Magyar Telekom, the former State-controlled telecommunications company which had a government-protected monopoly in the Hungarian domestic and international long distance wireline voice telecommunications market. Following a tender process, the Hungarian government awarded PanTel licenses to provide data transmission and other services that were not subject to Magyar Telekom s government-protected monopoly rights for long distance voice services. In 1999, PanTel began building along MAV s railroad rights-of-way what is now a 3,700 kilometer-long state-of-the-art fiber optic backbone telecommunications network. The network was built based on SDH/DWDM (synchronous digital hierarchy/dense wavelength division multiplexing) and Internet Protocol (IP) technology and can carry voice and data traffic on dedicated lines as well as voice and data over IP. PanTel s nation-wide backbone network enables it to service customers throughout the entire country. PanTel also built metropolitan area networks, including a metropolitan area network covering Budapest, which networks connect to PanTel s backbone network.

Until 2002 PanTel was only allowed to offer data and VoIP services in Hungary. When the Hungarian government ended Magyar Telekom s monopoly rights for long distance voice services, PanTel was able to compete with Magyar Telekom and offer all modern telecommunications services including traditional voice services. Customers can now choose their provider on a call-by-call basis through carrier selection (by dialing a 4 digit prefix) or on an automatic continuing basis through carrier pre-selection. PanTel s target market has been larger business customers with whom it can establish a direct high bandwidth fiber optic (fiber-to-the-premise) or a wireless point-to-point connection between

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the business customer s premises and PanTel s network. For these business customers, PanTel can meet all of the business customer s wireline telecommunications requirements by providing all of the capacity and bandwidth that the customer needs as well as high standard voice and high speed Internet services. PanTel has the authorization and the necessary network to utilize the 1.5 and 3.5 GHz wireless frequency blocks which enable PanTel to service smaller and medium-sized business customers with lower traffic and bandwidth requirements by connecting them to PanTel s backbone network with a wireless point-to-multipoint connection. For these customers, PanTel can provide high quality services without having to construct a direct physical connection to the business or lease an existing connection from another telecommunications service provider (through unbundling). See -Summary of the Communications Act-Significant Market Power.

In 2004 the Hungarian government took another step to increase competition in the telecommunications marketplace by implementing number portability. Customers are now free to switch telephone service providers and keep their existing phone numbers. Allowing customers, particularly business customers, to keep their phone numbers when they switch service providers took away one more hurdle to a competitive environment. PanTel is now able to compete primarily on price and service. PanTel can connect a new customer (switching service to PanTel) directly to the PanTel network by constructing a fiber optic or wireless connection to the customer s premises or by using the existing connection of the customer s former service provider under an interconnection or unbundling arrangement. See -Summary of the Communications Act-Significant Market Power.

Like Hungarotel, PanTel offers its business customers modern domestic and international telecommunications services over its high speed network and that of its international partners as well as the traditional voice services such as local calls and domestic and international long distance calls. PanTel also offers its business customers other services that businesses require including: high speed Internet access; data transport services including managed leased lines, ATM services, and frame relay services; virtual private networks; and Web Hosting. At the end of 2006, PanTel had approximately 59,000 telephone lines in service in the Corporate Market, including approximately 7,000 carrier pre-selection telephone lines.

In order to take advantage of PanTel s strengths, including its brand name which was already established country-wide, we revised our Mass Market strategy in 2006 and now use PanTel as our provider of services to the out-of-concession Mass Market outside the Hungarotel Operating Areas. At the end of 2006, PanTel serviced approximately 44,000 telephone lines in the out-of-concession Mass Market through carrier selection, carrier pre-selection and local loop unbundling services.

PanTel is also a wholesaler and sells capacity and transport services on its network to other wireline and wireless telecommunications providers, cable television operators and Internet Service Providers. PanTel s international network allows it to transfer voice, data and Internet traffic to and from Hungary.

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The following commercial maps depict PanTel s national and international networks.

Hungarotel and PanTel

Prior to our acquisition of PanTel, Hungarotel and PanTel had established a working relationship and were providing each other with various services. With the PanTel acquisition complete, we are now capitalizing on the synergies of a combined Hungarotel and PanTel. Hungarotel brings the combined

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entity its experience in the residential markets and local networks while PanTel provides its experience in the nation-wide business and wholesale markets and its international experience along with its backbone network.

The Hungarian Telecommunications Market

Hungary has a population of approximately 10.1 million. As of December 31, 2006, there were over 3.2 million fixed telephone lines in service in Hungary, which represents approximately 33 fixed telephone lines per 100 inhabitants with about 66.4% of all Hungarian residences having a fixed telephone line. There were over 9.9 million wireless phones in service representing a penetration rate of approximately 99% of Hungary s population.

The Parent Company

Our Common Stock is traded on the American Stock Exchange under the symbol HTC. Our principal office in Hungary is located at Dorottya Udvar, Bocskai ut 134-146, H-1113, Budapest; telephone (361) 888-3535. Our United States office is located at 1201 Third Avenue, Suite 3400, Seattle, Washington 98101-3034; telephone (206) 654-0204. Our Internet address is http://www.htcc.hu and it contains a link to our filings with the U.S. Securities and Exchange Commission (the SEC).

The Republic of Hungary

Hungary is located in Central Europe bordering on Austria, Slovenia, Croatia, Serbia, Romania, Ukraine and Slovakia. Six Western European capitals are within a one-hour flight. Its total area is approximately 93,000 square kilometers. It has approximately 10.1 million inhabitants, approximately 1.7 million of whom reside in Hungary s capital, Budapest.

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For nearly 40 years, Hungary had a one-party government and a centrally planned economy. Democracy was restored and the foundations of a market economy were built between 1988 and 1990. Free elections were held in 1990. Today, Hungary has a parliamentary democracy with a single-chamber National Assembly. As a result of a large scale privatization effort, private enterprise has become the basis of the Hungarian economy.

Since 1995, the Hungarian government has embarked on an economic stabilization effort aimed at putting the economy on a sustainable path of low-inflationary growth. The following table provides Hungary s annual GDP growth and inflation rates since 1995.

	Annual GDP % Growth Rate	Annual % Inflation Rate
1995	1.7	28.2
1996	1.3	23.6
1997	3.5	18.2
1998	5.0	14.5
1999	4.9	10.0
2000	5.3	9.8
2001	3.8	9.2
2002	3.5	5.3
2003	2.9	4.7
2004	4.0	6.8
2005	4.6	3.6
2006	3.9	3.9

The unemployment rate has decreased from 11.1% in 1995 to 7.5% in 2006.

Today Hungary is considered one of the most developed countries in Central and Eastern Europe. Since 2000, foreign direct investment, from countries around the world including the United States, the United Kingdom, Germany, Austria, the Netherlands, and Japan, has exceeded 13.6 billion (approximately $17.9 billion). The Hungarian government has undertaken increased efforts to create a positive and competitive business climate and infrastructure in order to attract investment capital. The Hungarian government is promoting Hungary as the logical regional hub for Central and Eastern Europe based on a knowledge-based economy, innovation and hi-tech industries. Hungary has seen increased investment in service and R&D centers as well as the electronics, automotive, IT, biotechnology, pharmaceutics, chemical and energy sectors of the economy. Foreign investors in Hungary include global companies such as Ericsson, ExxonMobil, Flextronics, GE, General Motors, GlaxoSmithKline, IBM, Microsoft, Nokia, Novartis, Oracle, Philips, Siemens, Volkswagen and Zoltek.

Hungary is a member of the European Union (EU), the North Atlantic Treaty Organization (NATO) and the World Trade Organization (WTO). Hungary s current target date to adopt the euro as its currency is 2011.

Overview of Hungarian Telecommunications Industry

The Hungarian Telecommunications Industry Prior to Privatization

In 1989, the Hungarian state-owned Post, Telegraph and Telephone (PTT) was divided into three separate companies: the Hungarian Broadcasting Company (Antenna Hungaria), the Hungarian

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Post Office (Magyar Posta) and Magyar Telekom. The Hungarian PTT was historically the exclusive provider of telecommunications services in Hungary. The Hungarian telecommunications market was significantly underdeveloped without the investment in the telecommunications infrastructure necessary to achieve a comparable level of teledensity to that of Western Europe. As of December 31, 1995, Hungary had a basic telephone penetration rate of approximately 21 telephone access lines per 100 inhabitants compared to a European Union average of approximately 48 telephone access lines per 100 inhabitants and a United States average of approximately 60 telephone access lines per 100 inhabitants. Of such access lines in Hungary, approximately 40% were located in Budapest (in which approximately 17% of Hungary s population resides). In the Hungarotel Operating Areas, access line penetration was approximately 9 telephone access lines per 100 inhabitants as of December 31, 1995.

Privatization of Magyar Telekom and Local Telephone Service

In 1992, the Hungarian government began the process of privatizing Hungary s telecommunications industry by selling an initial 30% stake in Magyar Telekom (raised to 67% in 1995) to MagyarCom, a company then wholly owned by Deutsche Telekom AG, the German public telephone operator (Deutsche Telekom), and Ameritech, a United States telecommunications company. In 1997, Magyar Telekom completed its initial public offering pursuant to which MagyarCom s stake in Magyar Telekom was reduced to approximately 60% and the Hungarian State s stake was reduced to approximately 6%. The Hungarian State also retained certain shareholder rights by retaining one Golden Share. In 1999, the Hungarian State sold its remaining 6% ownership interest in Magyar Telekom but retained its Golden Share. In 2000, Deutsche Telekom purchased the entire ownership interest of SBC Communications Inc. (Ameritech s successor) in MagyarCom. Today, MagyarCom owns 59.2% of Magyar Telekom while 40.8% is publicly traded on the Budapest and New York Stock Exchanges.

In 1992, the Hungarian government divided the country into 54 primary telecommunications service areas in order to take some of the primary telecommunications service areas out of Magyar Telekom s national network with respect to the provision of basic local wireline telephone services. Magyar Telekom was allowed to continue its monopoly in the provision of domestic and international long distance services through 2001. In 1993, the Hungarian government solicited bids for concessions to build, own and operate telecommunications networks in the 25 service areas which had been chosen to exit the Magyar Telekom system. The Hungarian government awarded 23 concessions out of the 25 that the Hungarian government solicited bids for. Holders of those 23 concessions today (each an Incumbent Local Telephone Operator, ILTO, and together the ILTOs) include: us (5 concession areas); Invitel owned by Mid Europa Partners, GMT Communications Partners and the management of Invitel (9 concession areas); Monor Communications Group (Monortel), part of Liberty Global, Inc., the global cable television operator based out of Colorado (NASDAQ:LBTYA) (1 concession area); and Magyar Telekom (8 concession areas). Magyar Telekom also retained the rights to service the 2 concession areas for which there were no successful bidders. Each of the ILTOs (including Magyar Telekom) received 25-year licenses to provide basic local wireline telephone services with exclusivity rights in their respective concession areas, which exclusivity rights all expired by the end of 2002. In addition to the fees paid to the government which aggregated approximately $80.0 million (at historical exchange rates), each of the non-Magyar Telekom ILTOs negotiated a separate asset purchase agreement with Magyar Telekom for each concession area s existing basic telephone plant and equipment, which led to the transfer of approximately 260,000 access lines from a total of 1.2 million access lines in the Magyar Telekom system. Today Magyar Telekom s basic local wireline telephone service areas cover approximately 72% of Hungary s population and approximately 70% of its geographic area.

Domestic and International Long Distance Services

The Hungarian government allowed Magyar Telekom to continue its monopoly in the provision of domestic and international long distance wireline voice services through 2001. In 1998, the Hungarian government awarded PanTel licenses to provide such services as data transmission, voice mail and other

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services, which were not subject to exclusive concessions. PanTel built its own country-wide telecommunications network. At the end of 2001, the domestic and international long distance market was officially opened up to competition when Magyar Telekom s right to provide exclusive domestic and international long distance wireline voice transmission expired. Other telecommunications service providers have since entered the market. See -Competition.

Wireless Services

In 1993, the Hungarian government awarded Westel (the predecessor to T-Mobile Hungary) and Pannon licenses to provide nation-wide digital wireless telephone services. Westel already had a license to provide analog wireless telephone services. T-Mobile Hungary is a part of Magyar Telekom and Telenor ASA (the Norwegian telecommunications company) owns 100% of Pannon.

In 1999, the Hungarian government awarded an additional digital mobile phone license to Vodafone Rt. (Vodafone), a subsidiary of Vodafone Group Plc., following a bidding process.

Market Liberalization; The Regulatory Framework

In 2001, the Hungarian government enacted its first significant market-oriented telecommunications act. The goal of this act was to provide for a more liberalized telecommunications market by making market entry easier, promoting competition and harmonizing Hungary s telecommunications laws with those of the European Union. In 2003, the Hungarian government enacted Act C of 2003 on Electronic Communications (the Communications Act). The goal of the Communications Act is to further promote competition and to harmonize Hungary s telecommunications laws with the European Union framework that was put into effect in 2003. The Communications Act is a framework piece of legislation with the detailed governing regulations contained in a series of implementing decrees.

Telecommunications services in Hungary are currently regulated by the Ministry of Economy and Transport of the Hungarian government (the Ministry) which is led by the Minister of Economy and Transport (the Minister). The National Communications Authority, a central administrative organization, reports to the Minister and the Hungarian government. The National Communications Authority is divided into two units: the Council of the National Communications Authority and the Office of the National Communications Authority. Hungarotel s operating concessions for local wireline telephone services from the Hungarian government were originally governed by individual concession contracts which have been substantially superseded by subsequent legislation. Negotiations with the Minister to amend or terminate Hungarotel s concession contracts are pending. See - Summary of the Communications Act.

The Hungarian Telecommunications Industry Today

Since 1994, the ILTOs, including Magyar Telekom, have spent over a billion U.S. dollars to build modern state-of-the-art telecommunications networks throughout Hungary. At the end of 2006, Magyar Telekom had approximately 2.644 million access lines connected to its telecommunications network, while Invitel, Monortel and Hungarotel (the other ILTOs) had approximately 348,000, 70,000 (estimated) and 138,000 access lines, respectively, connected to their local telecommunications networks. Hungarotel had 21 access lines per 100 inhabitants in its Hungarotel Operating Areas as compared to 33 access lines per 100 inhabitants in all of Hungary at the end of 2006.

In the domestic and international long distance market, other service providers have entered the market to compete with Magyar Telekom and PanTel. However, only Magyar Telekom and PanTel have nation-wide networks while Invitel has expanded its network out of its local service areas to a large part of Hungary.

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At the end of 2006, T-Mobile Hungary had a wireless phone customer base of 4.4 million, while Pannon s customer base was 3.4 million and Vodafone s customer base was 2.1 million. The overall penetration rate for wireless service in Hungary was approximately 99% at the end of 2006. The Hungarian government awarded each of three incumbent wireless providers a Universal Mobile Telecommunications System (UMTS or 3G) license in 2004 following a tender process. In late 2005, the three wireless carriers began rolling out their 3G service in Budapest. Since 2004, more than 50% of the total voice traffic market within Hungary has been handled by the 3 Hungarian wireless telephone service providers

In the Internet services market, all of the ILTOs are providing dial-up and broadband Internet service. There are also independent Internet Service Providers without telecommunications networks. Some of the cable television operators in Hungary are offering Internet services and UPC Hungary, the owner of the ILTO Monortel, and T-Kabel, a subsidiary of Magyar Telekom, have also introduced voice services over their cable television networks.

TDC

TDC A/S, formerly known as Tele Danmark A/S (together with its affiliates, TDC), owns 62% of our outstanding common stock (Common Stock) in the aggregate. Most of the remaining 38% of our outstanding Common Stock is held by the public and traded on the American Stock Exchange.

TDC, based in Copenhagen, Denmark, is the leading provider of communications solutions in Denmark, the second-largest telecommunications provider on the Swiss market and has a significant presence in the pan-Nordic market and in selected markets in Central Europe. In February 2006, Nordic Telephone Company ApS, a Danish entity owned by 5 private equity firms (NTC), completed its tender offer for the outstanding shares of TDC. NTC now owns over 87.9% of TDC.

At December 31, 2006, TDC had total assets of Danish Kroner 80.8 billion (approximately $14 billion) and shareholders equity of Danish Kroner 3.6 billion (approximately $637 million). For 2006, TDC had net income of Danish Kroner 3.44 billion (approximately $609 million) on net revenues of Danish Kroner 47.4 billion (approximately $8.4 billion).

As a result of certain agreements that we have entered into with TDC (the TDC Agreements), we have issued 2,579,588 shares of Common Stock to TDC. In 2002, TDC purchased 1,285,714 shares of Common Stock from a former stockholder of the Company. In 2004, TDC purchased an additional 1,383,544 shares of Common Stock and 18,000 shares of the Company s preferred stock convertible into 180,000 shares of Common Stock that were held by another former stockholder of the Company. In 2005, TDC purchased, from another former stockholder of the Company, an additional 2,750,936 shares of Common Stock, warrants to purchase 2,500,000 shares of Common Stock, 12,000 shares of the Company s preferred stock convertible into 120,000 shares of Common Stock, and notes issued by the Company in the principal amount of $25 million. As of March 12, 2007, TDC owned 62% of the outstanding Common Stock and 66% of the outstanding Common Stock on a fully diluted basis. The TDC Agreements provide TDC with certain preemptive rights to purchase, upon the issuance of Common Stock in certain circumstances to third parties, shares of Common Stock in order to maintain its percentage ownership interest of the outstanding Common Stock. See Notes 6, 7 and 15 in Notes to Consolidated Financial Statements, and see also Item 12 Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters and Item 13 Certain Relationships and Related Transactions, and Director Independence.

Directors and Officers

The members of our current Board of Directors include: Jesper Theill Eriksen (Chairman), the President of TDC Mobile International, a business unit of TDC; Ole Steen Andersen, a member of the

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Executive Committee and the Chief Financial Officer of Danfoss A/S, a Danish company; Ole Bertram, our former President and Chief Executive Officer; Robert R. Dogonowski, a director in TDC s Corporate Business Development department; Jens Due Olsen, an Executive Vice-President and the Chief Financial Officer of GN Store Nord A/S, a Danish company; Carsten Dyrup Revsbech (Vice-Chairman), the Chief Financial Officer of TDC Mobile International; John B. Ryan, a retired financial consultant; and Henrik Scheinemann, a Vice-President of TDC Mobile International. Our executive officers are Torben V. Holm, President and Chief Executive Officer; Steven Fast, Chief Financial Officer; Peter T. Noone, General Counsel and Secretary; Tamas Vagany, Chief Commercial Officer (Domestic); and Alex Wurtz, the head of our Corporate Business Development. Messrs. Holm, Fast, Vagany and Wurtz comprise the Executive Committee of management.

The Hungarotel Operating Areas

The following is a brief description of each of the Hungarotel Operating Areas:

Bekes

Our Bekes operating region encompasses the southern portion of Bekes County, which borders Romania. The Bekes operating region is comprised of 75 municipalities and has a population of approximately 391,700 with an estimated 166,900 residences and 23,100 business and other potential customer (including government institutions). Bekes is the most intensively cultivated agrarian region in Hungary and produces a substantial portion of Hungary s total wheat production. Industry, generally related to food processing, glass and textile production, is also a strong employer in the region. Foreign investors in the operating region include Owens-Illinois of the United States and a number of European manufacturers. The region is also a center for natural gas exploration and production. As of December 31, 2006, we had 73,900 access lines connected to our network in the Bekes operating region. Our network in the Bekes operating region utilizes a combination of a conventional build, fiber optic and wireless local loop technology.

Nograd

Our Nograd operating region is comprised of 76 municipalities in the eastern portion of Nograd County, which borders Slovakia. The Nograd operating region has a population of approximately 147,900 with an estimated 62,400 residences and 8,900 business and other potential customers (including government institutions). The principal economic activities in the Nograd operating region include light manufacturing, tourism, some coal mining and agriculture. Foreign investors in the region include the Italian-owned dairy producer, Sole, and the German company, Paramount Glass. The Nograd operating region s proximity to Budapest, 1.5 hours by car, and its many cultural attractions makes it a desirable weekend and tourist destination. As of December 31, 2006, we had 31,700 access lines connected to our network in the Nograd operating region. Our network in the Nograd operating region utilizes a combination of a conventional build, fiber optic and wireless local loop technology.

Papa/Sarvar

Our Papa/Sarvar operating region is composed of 114 municipalities located in the counties of Veszprem and Vas. The population of the Papa/Sarvar operating region is approximately 128,400 with an estimated 50,300 residences and 6,500 business and other potential customers (including government institutions). The portion of the Papa/Sarvar operating region in Veszprem County is relatively underdeveloped economically with the principal economic activities centered around light industry, appliance manufacturing, agriculture and forest products. Foreign investors in Veszprem County include Electricité de France. The principal economic activities in the portion of the Papa/Sarvar operating region located in Vas County include heavy manufacturing and assembling, agriculture and tourism. Significant employers in Vas County include: Linde (a German natural gas distributor); Flextronics (an electronics

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components assembler); and Saga (a British-owned poultry processor). As of December 31, 2006, we had 32,500 access lines connected to our network in the Papa/Sarvar operating region. Our network in the Papa/Sarvar operating region utilizes a combination of a conventional build, fiber optic and wireless local loop technology.

Network Design

Hungarotel has versatile modern telecommunications networks which substantially replaced the antiquated systems purchased from Magyar Telekom. The networks provide many of the technologically advanced services currently available in the United States and Western Europe. Most of Hungarotel s networks are based on digital hosts and remotes with fiber optic rings and copper feeder and distribution. Such a distribution system is the conventional system used in the United States and Western Europe. Telecommunications services are transmitted to the home through twisted pair copper wire telephone cable. We have replaced all manually operated local battery and common battery cord type switchboards purchased from Magyar Telekom and have replaced all of the analog switching systems with digital technology in order to provide the latest features and services. Hungarotel s conventional networks have been designed to employ an open architecture, generally using Synchronous Digital Hierarchy (SDH) technology for system resilience. Hungarotel s networks are designed to provide voice and high speed data services. We believe that the flexible design of Hungarotel s conventional networks allows us to readily implement new technologies and provide enhanced or new services. Hungarotel s switches in its conventional networks allow it to connect to networks operated by the other ILTOs, and the long distance carriers such as Magyar Telekom and PanTel in order to route voice and data transmissions.

PanTel built a nation-wide state-of-the-art fiber optic backbone network based on SDH/DWDM and Internet-Protocol technology linking every county in Hungary. The network provides fiber optic access to every major city within each Hungarian county. Within these cities PanTel has microwave access networks which cover up to a 20 to 30 kilometer range around each city. PanTel s network enables it to provide all of its customers capacity and bandwidth requirements for voice, data and Internet transmission. PanTel built a metropolitan area network in Budapest, which network connects to the PanTel backbone network allowing PanTel access to Hungary s capital. PanTel has city-wide coverage in Budapest with point-to-point and 3.5 GHz point-to-multipoint wireless systems.

In some areas, when geographic conditions make it more feasible, Hungarotel is utilizing a wireless network technology based upon the Digital Enhanced Cordless Telecommunications (DECT) system which interfaces radio technology to fiber-optic, digital microwave, or fixed copper networks. Hungarotel is deploying a fiber optic cable to the node in the same fashion as in a conventional network build-out. At each node, we have constructed a radio base station (RBS), rather than switching to twisted pair copper wire distribution to the home. Each RBS has the capacity to provide service to between 60 and 600 customers. As additional customers are brought onto the network, we will install a transceiver unit at the customer s premises. Such transceiver s operating software is digitally encrypted so that it will operate only with its supporting RBS. A conventional telephone jack is then installed in the customer s household near an electrical outlet which is used to power the transceiver unit. The customer then uses a conventional phone to make outgoing and receive incoming calls. The DECT-based wireless local loop system provides the same type and quality of services as a conventional telephone network (except for DSL service), including such services as voice mail, call forwarding and call blocking. When an expedited connection is required, the DECT system can connect the customer quickly while a wireline connection is being constructed.

PanTel is deploying a wireless connection to certain businesses with much more bandwidth capacity than Hungarotel s wireless system. Rather than deploying a fiber optic connection to the business s premises, PanTel can use its wireless 3.5 GHz frequency band. This enables lower traffic and bandwidth customers (smaller and medium-sized businesses) to be connected to the PanTel backbone network.

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We have interconnection arrangements in place with the other significant Hungarian wireline telecommunications service providers and all three Hungarian wireless providers. PanTel s network also crosses Hungary s borders and extends into other countries in the Central and Eastern European region including Austria, Bosnia & Herzegovina, Bulgaria, Croatia, the Czech Republic, Macedonia, Romania, Serbia, Slovakia, Slovenia, Turkey and Ukraine. To service our customers global telecommunications needs, PanTel has interconnection agreements with several major international telecommunications service operators which provide for interconnection at major international telecommunications hubs, including Frankfurt, London and Vienna.

Network Administration

Both Hungarotel and PanTel continually monitor their networks with modern technology to ensure uninterrupted and high quality service. Both entities are able to evaluate and respond promptly and appropriately to any network failures.

The Market/Tariff and Fee Structure

Background

The ILTOs, including Hungarotel, Invitel and Magyar Telekom, had government-protected exclusivity rights to provide local wireline voice services in their concession areas, which exclusivity rights expired by the end of 2002. Magyar Telekom also had exclusive rights to provide wireline long distance voice services throughout Hungary, which rights expired at the end of 2001. While competition was officially sanctioned in both the local and long distance voice markets prior to the adoption of the Communications Act, it took the enactment and implementation of the Communications Act to accelerate competition, particularly the introduction in 2004 of number portability and the revision of regulations regarding carrier selection, carrier pre-selection and the requirement for the ILTOs to provide network access and local loop unbundling which allows third party service providers to use the ILTOs networks to compete with the ILTOs. These changes, along with the vigorous enforcement of such regulations by the Hungarian regulators, have truly stimulated competition. See -Summary of the Communications Act.

A Hungarian customer may now pre-select a telecommunications service provider to provide (i) local and domestic long distance service and (ii) international service. A customer may choose the same service provider to provide both (i) local and domestic long distance service and (ii) international service. Therefore, while Hungarotel, Magyar Telekom and the other ILTOs still retain their rights to provide telecommunications services, they are subject to competition in their home markets from each other and from new entrants into the market. Competitors can enter these markets either by building out their own networks (an overbuild) or by using the existing network of the ILTO through either interconnection or an unbundling agreement. See -Summary of the Communications Act-Significant Market Power.

With the stated goal of further promoting competition and getting interconnection rates in line with EU rates, the Hungarian government has required the ILTOs to significantly reduce their interconnection rates in 2004, 2005 and 2006. This makes it easier for a competitor to enter one of the Hungarotel Operating Areas and take a customer away from Hungarotel while using Hungarotel s network to service that customer. That service provider can now provide the customer with local and long distance services with a minimal investment. That competitor could use Hungarotel s connection to the customer to service outgoing calls and pay a per minute interconnection fee to Hungarotel. In this case, Hungarotel would still receive a monthly subscription fee from the customer for supplying the line connection to the premises. Conversely, Hungarotel and PanTel can go into markets outside of the Hungarotel Operating Areas and compete with the ILTO using that ILTO s network. See -Summary of the Communications Act-Significant Market Power.

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Hungarotel s fees and retail tariffs are regulated while PanTel s fees and tariffs are not regulated. See -Summary of the Communications Act-Significant Market Power and -Price Regulation.

Revenue

Hungarotel s revenues are primarily derived from the provision of local and long distance (domestic and international) telephone services which consist of (i) charges for measured telephone service, which vary depending on the day, the time of day, distance and duration of the call, and (ii) subscription fees. Hungarotel is also permitted to charge its customers connection fees. Hungarotel also receives other operating revenues consisting principally of charges and fees from leased lines, fees for the provision of broadband DSL and dial-up Internet services, detailed billing, voice mail, caller ID and other customer services, including revenues from the sale and lease of telephone equipment. PanTel s revenues are derived from (i) local, domestic and international long distance voice and data services, (ii) Internet services, and (iii) similar to Hungarotel, fees for value added services like voice mail and caller ID and such business oriented services as the provision of leased lines and virtual private networks. In addition, PanTel derives revenues from the wholesale market - transporting voice, data and Internet traffic and providing leased line services for other telecommunications service providers, cable television operators and Internet Service Providers.

Measured Service

Hungarotel has two basic rates for outgoing calls, peak and off-peak, for each of local and domestic long distance calls and calls to Hungarian wireless phones within Hungary. All of Hungarotel s rate packages include a set amount of calling minutes within the package. The rates for outgoing international long distance calls are based solely on the country called and do not depend on the time of day that the call is made. In response to regulatory and market pressures, in 2005 Hungarotel increased the number of available rate packages and rebalanced its tariff structure to increase the monthly subscription fees and decrease the variable rate fees for measured service. PanTel derives fees from measured service as well from both its Mass Market and Corporate Market customers. PanTel has competitive peak and off-peak set tariffs but also negotiates special customized rate plans, including bundled packages of services, for most of its larger business customers who generate a significant volume of traffic. The measured service fee scheme is summarized below.

Local Calls - For all local calls between its customers within a Hungarotel Operating Area, Hungarotel retains all of the revenues associated with the call. For PanTel's Mass Market and Corporate Market customers, local calls to non-Company customers require the payment of a per minute interconnection fee to the telecommunications service provider of the recipient for completing the call.

Outgoing Domestic and International Long Distance Calls (Non-LLU, Non-Carrier Selection and Non-Carrier Pre-Selection Customers) - For calls between our customers, we have the capability to carry the call from the calling party to the receiving party entirely over our telecommunications networks. For such calls, we keep the entire revenue collected from our customers. For domestic calls initiated by one of our customers to another service provider s customer, we have the network capability to deliver the call to the local telecommunications network containing the party receiving the call. In such cases, we collect a fee for the domestic long distance call from our customer and pay a per minute interconnection termination fee to the telecommunications provider completing the call. Prior to our acquisition of PanTel, Hungarotel had to, in some cases, arrange for either Magyar Telekom or PanTel to transport the call to the local telecommunications network containing the party receiving the call. Today, PanTel can transport all of these calls. For international calls, we have to transfer the call to one of our international service partners for completion. We must then pay, directly or indirectly, a per minute termination fee to the telecommunications provider completing the call, and, in some cases, a per minute transmission fee to the telecommunications provider who transports the call from our network to the local telecommunications network of the telecommunications provider who completes the call. With PanTel s

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international network, we can deliver the calls to various countries in the Central and Eastern European region. For other calls, we can use PanTel s network and transfer the calls for completion to one of our international partners at one of the major international telecommunications hubs, including Frankfurt, London or Vienna.

Outgoing Domestic and International Long Distance Calls (LLU, Carrier Selection and Carrier Pre-Selection Customers - For calls between our customers, we have the capability to carry the call from the calling party to the receiving party entirely over our telecommunications networks. For such calls, we keep the entire revenue collected from our customers but have to pay the ILTO that owns the connection to our customer either a per minute interconnection fee (carrier selection and carrier pre-selection customers) or a monthly fee (LLU customers). For domestic calls initiated by one of our customers to another service provider s customer, we have the network capability to deliver the call to the local telecommunications network containing the party receiving the call. In such cases, we collect a fee for the domestic long distance call from our customer and pay a per minute interconnection termination fee to the telecommunications provider completing the call in addition to the per minute interconnection fee or monthly fee to the ILTO that owns the connection to our customer. For international calls, we have to transfer the call to one of our international service partners for completion. We must then also pay, directly or indirectly, a per minute termination fee to the telecommunications provider completing the call, and, in some cases, a per minute transmission fee to the telecommunications provider who transports the call from our network to the local telecommunications network of the telecommunications provider who completes the call. See -Summary of the Communications Act-Significant Market Power.

Incoming Domestic and International Long Distance Calls - For domestic and international long distance calls to one of our customers from customers of other service providers, we receive a per minute interconnection fee for completing the call. For our carrier selection and carrier pre-selection customers, we do not receive any fees for incoming calls. Hungarotel s fees for completing these calls are regulated. See -Summary of the Communications Act-Significant Market Power.

Wireless Calls - Our networks directly interconnect with the three Hungarian wireless phone carriers networks. For calls by our customers to Hungarian wireless phones, we must pay a per minute fee to the wireless carrier for completing the call. The fees charged by the Hungarian wireless phone carriers for terminating calls are regulated. The prices charged for Hungarian wireless phone calls to our customers are unregulated and set by the wireless carriers. The wireless carriers pay us a per minute interconnection fee for completing wireless calls to our customers. For our carrier selection and carrier pre-selection customers, we do not receive any fees for incoming calls from wireless phones. Hungarotel s fees for completing these calls are regulated while PanTel s fees are not. See -Summary of the Communications Act-Significant Market Power.

Internet Services - Hungarotel provides dial-up and broadband DSL Internet services to its Mass Market customers. For dial-up Internet service, Hungarotel charges its Internet customers for both the telephone usage and the Internet usage. Hungarotel offers its dial-up Internet customers monthly packages consisting of a flat monthly discounted fee for the telephone and Internet usage for a fixed amount of monthly hours with variable telephone and Internet charges for Internet usage beyond the monthly limit. Lower usage dial-up Internet customers can pay a per hour fee for telephone and Internet usage without a monthly fee. For the broadband DSL Internet service, Hungarotel charges a combined monthly fee for both the high-speed access and the Internet service for an unlimited amount of time. When a third party Internet Service Provider provides Internet service to a Hungarotel customer, Hungarotel receives monthly access and usage fees from the third party Internet Service Provider plus, in the case of dial-up Internet service, variable fees from its telephone customer for the telephone usage which fees have to be shared with the third party Internet Service Provider. PanTel offers similar packages of dial-up and broadband DSL Internet service to the Mass Market outside the Hungarotel Areas but pays access charges to the ILTOs. See -Summary of the Communications Act-Significant Market Power-Internet Service. PanTel provides high speed Internet access to its Corporate Market customers at set prices or, in some cases, as part of a customized bundled service package.

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Subscription Fees

Hungarotel collects a monthly subscription fee from its customers. Hungarotel has multiple pricing packages to choose from with each package containing different monthly subscription fees, different rates for the measured service per minute fees, and different amounts of free minutes included within the monthly subscription fee. In 2005 Hungarotel increased the number of available rate packages and rebalanced its tariff structure to increase the monthly subscription fees and decrease the variable rate fees for measured service. For PanTel's Mass Market customers, it receives a subscription fee only when it is a LLU customer, for which PanTel leases the line to its customer on a monthly basis from the ILTO. Dependent upon the terms of agreement for service, PanTel may charge its Corporate Market customers a subscription fee. See -Summary of the Communications Act-Significant Market Power and -Price Regulation.

Connection Fees

Both Hungarotel and PanTel charge their Mass Market customers connection fees upon initiation of service. Occasionally, Hungarotel and PanTel offer special promotions on the connection fees. Dependent upon the terms of agreement for service, PanTel may charge its business customers in the Corporate Market a connection fee. See -Summary of the Communications Act-Price Regulation.

Other Operating Revenue

We supply private line service (point-to-point and point-to-multi-point), virtual private networks and other services primarily to the Corporate Market. We generate additional revenues from the provision of value-added services, including ISDN, voice mail, call waiting, call forwarding, and three-way calling, as well as through the sale and rental of telephone equipment.

Wholesale Services

PanTel provides wholesale telecommunications services, which includes transporting voice, data and Internet traffic for other telecommunications service providers, cable television operators and Internet Service Providers. PanTel also provides leased line services to this market. For example, PanTel provides transport services to the Hungarian wireless providers as well as cable television operators that have begun offering voice services. PanTel also provides transport services for Hungarian Internet Service Providers, including cable television operators providing Internet services. With its international network and international partners, PanTel can transport voice, data and Internet traffic into, and out of, Hungary for, and to, its international partners.

Strategy

Due to statutory and regulatory developments, competitors are no longer hindered by historical barriers to entry. With intense competition fully in place in Hungary resulting from market and regulatory forces, we face new opportunities and challenges. We believe that such factors as pricing, customer service and bundling of product offerings are the key factors in maintaining or increasing market share. Our goal is to provide the broadest array of telecommunications services with exceptional quality and service at reasonable prices by becoming the most efficient full service telecommunications provider in Central and Eastern Europe. Our strategy is currently focused on three key markets: the Mass Market; the Corporate Market; and the Wholesale Market.

Mass Market. The Mass Market consists of Hungarian residences and small office/home office (SoHo) (generally with 10 employees or less) customers. Hungarotel provides services to the Mass Market within the Hungarotel Operating Areas (in-concession), while PanTel provides services to the Mass Market outside the Hungarotel Operating Areas (out-of-concession).

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In-Concession - Hungarotel is the dominant ILTO in the Hungarotel Operating Areas competing against other wireline service providers, wireless service providers, resellers, and the cable television providers that are now competing with telephone services in the Hungarotel Operating Areas. Due to increased competition and regulatory mandated changes to Hungarotel s tariff structure, Hungarotel lost a significant amount of customers in 2005. In 2006, in an effort to stabilize the losses in its customer base, reconnect lost customers, and acquire new customers, Hungarotel (i) revamped its sales force; (ii) refocused its efforts on customer service; and (iii) restructured its product offerings with highly competitive pricing packages, special packages to reconnect disconnected customers, and discounted prices for broadband DSL Internet service. Hungarotel s goal was to transition its customers away from lower-priced subscription packages which contained higher variable usage charges to higher-priced subscription packages which contain more variable minutes included in the base subscription fee. As a result of its efforts, Hungarotel stabilized the losses in its customer base to below national averages, transitioned more of its customers over to the higher-priced subscription packages which have a higher ARPU, significantly increased its broadband DSL Internet service penetration rate, and improved its customer satisfaction ratings.

Hungarotel continues to capitalize on its brand awareness in the in-concession Mass Market by marketing itself as the known service provider that has brought modern telecommunications services to the cities and villages of the Hungarotel Operating Areas at fair prices with exceptional customer service. Hungarotel s marketing efforts include advertising on radio and television, door-to-door marketing, newspaper advertising, participation in local trade shows, direct mail, community meetings, billboard advertising and sponsorships. Since many Hungarians prefer face-to-face personal marketing, Hungarotel is leveraging the benefits of having a customer service center in each Hungarotel Operating Area to give personal demonstrations.

One of our goals is to generate more revenue from Internet services, specifically broadband DSL Internet service, to compensate for the lost revenue from voice services. The Hungarian government is promoting Hungary as the logical regional hub for Central and Eastern Europe based on a knowledge-based economy, innovation and hi-tech industries. As part of this effort, the Hungarian government has been promoting the use of the Internet throughout Hungary. Most schools have Internet access and an estimated 40% of Hungarian residences have a computer. An estimated 23% of Hungarian households have broadband Internet access. While Hungary s Internet access is currently at the low end of the EU spectrum, the percentage of Internet users with broadband access is high compared to Western Europe where a large dial-up Internet access base set the stage for widespread broadband adoption. But Hungary has adopted an Internet to All 10-year program to be funded, in part, with funds from the EU. Hungary has also adopted a National Broadband Strategy to increase broadband Internet access. While the Internet penetration for the Hungarotel Operating Areas is lower than Hungary as a whole, we believe that both dial-up and broadband Internet access are long-term growth industries in Hungary as the Hungarian economy progresses within the EU. Internet growth can generate additional telecommunications revenue. We are continuing to offer innovative incentives to increase the Internet services penetration rate in the Hungarotel Operating Areas and throughout Hungary, including special introductory rates for broadband DSL Internet access. See -Summary of Communications Act-Significant Market Power-Internet Service.

Out-of-Concession - To compensate for the loss of customers in the Hunga