

FairPoint Communications, Inc.
State of New Hampshire
Docket No. DT 07-011

Respondent: William E. King
Title: President, JSI Capital Advisors,
LLC and JSI Transaction
Advisors, LLC

REQUEST: Office of Consumer Advocate - Rebuttal

DATED: September 19, 2007

ITEM: OCA R-22 Refer to page 11, lines 13-22, of the Rebuttal Testimony of William E. King.

- a. Please provide documents and workpapers for any other company specific expense analyses or expense decompositions performed for the guideline companies; and
- b. Provide documents and workpapers for any other company specific revenue analyses or revenue decompositions performed for the guideline companies.

REPLY: **OBJECTION:** FairPoint objects to Data Request R-22 on the grounds that it is overbroad, unduly burdensome, and seeks highly confidential and proprietary commercial and strategic information that would provide competitors a business advantage if disclosed. The information sought pertains to the provision of competitive services and includes trade secret information that required significant effort and cost to produce and/or confidential, research or commercial information, including customer, geographic, market and product-specific data. FairPoint further objects to Data Request R-22 on the grounds that it may seek confidential or proprietary information of a third party which FairPoint is not authorized to disclose. FairPoint further objects to Data Request R-22 to the extent it seeks information protected from production by the attorney-client privilege and/or attorney work product doctrine. Subject to and without waiving these objections, FairPoint will produce non-privileged responsive information in its custody, possession or control. [Objection served September 25, 2007.]

All workpapers prepared in connection with company specific revenue

and expense analyses and decompositions performed for the guideline companies have been provided pursuant to FairPoint Data Response OCA R-15. Other documents referenced in connection with such analyses include Form 10-K, Form 10-Q and other documents filed by the guideline companies with the Securities and Exchange Commission. These documents are available at www.sec.gov.

ALASKA COMMUNICATIONS SYSTEMS GROUP INC

FORM 10-K (Annual Report)

Filed 3/14/2007 For Period Ending 12/31/2006

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Industry	Communications Services
Sector	Services
Fiscal Year	12/31

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Table of Contents

securities laws, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, changed circumstances or any other reason after the date of this Form 10-K.

Investors should also be aware that while we do, at various times, communicate with securities analysts, it is against our policy to disclose to them any material non-public information or other confidential information. Accordingly, investors should not assume that we agree with any statement or report issued by an analyst irrespective of the content of the statement or report. To the extent that reports issued by securities analysts contain any projections, forecasts or opinions, such reports are not our responsibility.

Our Company — ACS

Headquartered in Anchorage, we provide customer-focused, facilities-based, integrated telecommunications services. We operate the largest local telephone network in Alaska. We believe we offer strong growth opportunities premised on a customer-focused marketing strategy targeted at a growing customer base using products and assets matching the highest growth segments of the industry. We seek to offer our customers a “one-stop-shop” for their telecommunication needs, while reducing our back office costs.

We own and operate our infrastructure for local and long distance telephone, Internet, and wireless services. Currently, no other Alaskan provider owns such an infrastructure. We also operate the only statewide wireless network using code division multiple access (“CDMA”) technology through which we offer very high speed mobile data using “third generation,” or 3G, Evolution Data Optimized (“EV-DO”) technology. In addition, we offer satellite television through our partnership with DISH Network. Using our diverse product mix, we bundle our products to gain market share and increase our share of our customers’ telecommunications spending. We believe this strategy, combined with a strong financial foundation and a dividend program, provides us with a strong position for future growth.

ACS Group is a Delaware corporation, incorporated in October 1998. We began operations in May 1999 when we completed the acquisition and integration of four local telephone companies in Alaska. Each of these companies had been operating in its local market for over 50 years. Since 1999, we have built our network and service capabilities under a single brand name, Alaska Communications Systems (“ACS”) and as an integrated company, we have provided the leading facilities-based telecommunications services in Alaska. Using our strong ACS brand name and state of the art network, we have generated stable revenues and cash flow since 2000 and increased our market share in two of the highest growth areas of telecommunications: wireless and Internet services.

Our Market — Alaska

We target our products and services at a growing customer base with strong telecommunications spending habits. For the three year period from 2003 to 2005, the average median household income in Alaska was 22.4% higher than the average in the rest of the United States, and Alaskans spent 33% more on communications services than other Americans. According to the U.S. Census Bureau, over the five years ending 2006, the Alaskan population has increased 6.0%, nearly 20% higher than the national average. Additionally, Alaska has lower-than-U.S. average wireless service penetration, which provides us with opportunities to quickly move into new markets.

We have successfully grown our retail relationships. As of December 31, 2006, we served 446,438 retail relationships. A “retail relationship” refers to one service provided to one customer, and therefore, a customer may, and often does, engage with us in multiple retail relationships. The following table sets forth our retail relationship growth since December 31, 2004.

	As of December 31,		
	2006	2005	2004
Local	194,815	199,341	206,209
Wireless	130,971	112,854	94,232
Internet	56,657	53,245	47,553
Long Distance	63,995	56,317	47,050
	<u>446,438</u>	<u>421,757</u>	<u>395,044</u>

Table of Contents

Despite the further potential for growth in our market, we believe that Alaska's large geographic size and isolated markets of both major metropolitan areas and small, dense population clusters reduces the likelihood of entry by new competitors offering integrated, facilities-based services. As a result, we believe our already strong market presence will continue to contribute to our stability and growth and provide us with an advantage relative to other telecommunications markets.

Our Services — At a Glance

We have provided a summary of the services we provide below. For a more detailed discussion of our services, please see, “ — Products, Services and Revenue Sources” below.

Local telephone . We provide local telephone service to approximately 253,000 access lines, representing approximately 57% of the local access lines in Alaska. We generate local telephone revenue from providing local telephone service to consumer and business customers and by providing access to our network and back office functions to other telecommunications companies. At December 31, 2006, approximately 50% of our retail access lines served residential consumers and 50% served business customers.

Wireless . We provide statewide mobile and fixed voice and data communications services to approximately 134,000 wireless subscribers throughout Alaska. Our wireless networks have a covered population of approximately 542,000, representing approximately 81% of the state's population, according to the 2006 U.S. Census Bureau estimates. We serve approximately 24.7% of our covered population. In 2005 and 2006, we aggressively expanded our CDMA 1xRTT and EV-DO network, which features advanced mobile data services. We expect to substantially complete our expansion of this network in 2007. We also provide wireless services using our time division multiple access (“TDMA”) digital network which we maintain for subscribers who have not yet upgraded to CDMA.

Internet . We provide Internet access services to approximately 57,000 subscribers, including high-speed digital subscriber line (“DSL”) service to approximately 44,000 subscribers. Our DSL service is currently available to approximately 75% of our local telephone access lines. As part of our Internet services, we also provide advanced IP-based private networks to large enterprise and governmental customers in Alaska.

Interexchange . We offer long distance and interexchange private-line services primarily as a facilities-based carrier to approximately 64,000 long distance customers.

Video . We offer customers in Alaska satellite video entertainment through our partnership with the DISH network.

For the fiscal year ended December 31, 2006, 54.9%, 33.0%, 7.2% and 4.9% of our revenues came from local telephone, wireless, Internet, and interexchange services, respectively. For more detailed information, please see “ — Products, Services and Revenue Sources” below.

Competitive Strengths and Business Strategy

We seek to maintain and grow our cash flow and investor returns as the premier telecommunications services provider in Alaska. While the communications marketplace converges and competition continues to enter the market, we plan to achieve our goals through the following principal strategies:

Use our existing strong competitive position to grow our retail relationships. We believe we already have the leading competitive position in Alaska.

- We are the incumbent local telephone company in all of Alaska's major population centers and more than 70 other communities;
- We are the only provider of mobile broadband wireless service, and the second largest wireless communications services provider; and
- We are the largest provider of DSL services and the second largest provider of Internet access services.

We build upon this leading competitive position with an eye to the future of communications, and we seek to offer the most advanced products and services to our large customer base.

Table of Contents

Develop and offer new products targeted at the highest-growth markets. We currently offer products in two of the highest-growth telecommunications markets: wireless and Internet. In each of these markets, we own and operate our networks. We believe our facilities-based strategy places us in an advantageous position relative to our competitors who do not offer similar facilities-based services in each of these high-growth markets. Our primary competitor, General Communication, Inc. (“GCI”) offers facilities-based cable Internet services that compete directly with our high-speed DSL services. Further, GCI has begun deploying cable telephony, through which it provides facilities-based local telephone service. However, GCI primarily resells wireless services through a partnership with Dobson Cellular Systems, Inc. (“Dobson”), our main wireless competitor. Dobson operates only wireless facilities. Thus, among our primary competitors, we believe we offer the optimal mix of products designed to help us benefit from high-growth areas in the industry. We expect to continue developing new products in these high-growth areas to enhance our competitive position.

Maintain advanced networks and facilities. We have designed our wireless and wireline networks to accommodate developing products and technology. We operate a Multi-Protocol Label Switching over Asynchronous Transfer Mode (“MPLS/ATM”) network. Because our advanced MPLS/ATM network uses standard protocols, we can offer our customers a complete suite of integrated telecommunications services, while achieving significant operating efficiencies. The enhanced products that converge over our MPLS core network include the following:

- virtual private networks and lines;
- voice over Internet Protocol services;
- transparent local area networks (“LANs”) and proprietary LANs and wide area networks (“WAN”);
- high speed Internet access;
- managed services; and
- video conferencing.

In addition, we provide the only statewide mobile broadband wireless service, and we are the second largest provider of Internet access service in Alaska. We aim to provide wireless service primarily through our state-of-the-art CDMA 1xRTT and EV-DO wireless network. This state-of-the-art network currently serves 95% of our wireless subscribers, and we anticipate 100% of our subscribers will be served by our CDMA network by year-end 2007. In addition to our CDMA network, we maintain a secondary TDMA digital network for our non-CDMA subscribers. Our growing CDMA network has allowed us to expand our wireless network coverage and to offer a wider range of wireless and mobile broadband data services. We believe our expanded wireless services, compared to our competitors, will allow us to capture new retail relationships and win back wireline subscribers with integrated offerings.

Offer integrated, customer-focused services. We believe we offer the leading portfolio of integrated communications services to Alaskans, including local telephone, wireless, Internet, long distance, messaging, video entertainment, and other services. We believe that offering our customers bundled packages results in customer subscription to a greater number of our products and services and is a key component of our success. Bundling allows our customers a “one stop shopping” experience, fewer billing statements, and greater value for price across a number of services. In 2005, we began our “ON ACS” program, through which we offer discounts to customers subscribing to both our local telephone and wireless services at prescribed service levels. Our ON ACS program, as well as our bundled offerings, allows us to use our advanced CDMA 1xRTT and EV-DO wireless network and our high-speed DSL service to gain long distance and local telephone subscribers.

Recruit and maintain a strong, experienced management team. We have a highly experienced senior management team with an average of approximately 13 years of experience in the local telecommunications industry and a proven track record of operating and managing integrated telecommunications companies. Our executive management team has broad experience in the telecommunications industry and understands the dynamics of the Alaskan markets and our customers. Liane Pelletier joined us in October 2003 as CEO and President and became Chairperson of our board of directors on January 1, 2004. Before joining us, Liane worked for 17 years at Sprint Corporation, most recently as a member of the Executive Management Committee and as Chief Integration Officer. David Wilson, who was previously Chief Financial Officer of Triumph Communications and DIRECTV Broadband, joined us as our Chief Financial Officer in March 2004. In addition, in 2003, David C. Eisenberg joined us from Sprint as Senior Vice President, Corporate Strategy, Development and Marketing and in February 2004, Sheldon Fisher joined us from Sprint as Senior Vice President, Sales and Service. Most recently, in August 2006, Anand Vadapalli, joined us as Senior Vice President, Network and IT Operations. Prior to joining us, Anand served as the Vice President, Information Technology at Valor Telecom.

Table of Contents

Review and improve internal processes to increase efficiency. We formed and continue to maintain "Process Improvement Teams". The goal of these teams is to remedy known inefficiencies in various areas of our company. To date, the teams have improved our customer service by reducing set up times for DSL, shortening wait time for customer calls allowing more time for problem resolution and sales, and designing clearer billing statements, which resulted in fewer customer complaints and inquiries. Our teams have also increased the accuracy of forecasting for service procurement, reduced time required to provision circuits, and designed a company-wide product development process through which all new products undergo rigorous analysis, troubleshooting, and testing before they enter the market.

Products, Services and Revenue Sources

We generate revenue from the provision of local telephone, wireless, Internet, and interexchange services. The following table sets forth the components of our consolidated revenues for the years ended December 31, 2006, 2005, and 2004:

	Revenue for the Year Ended December 31, (in millions)					
	2006		2005		2004	
	Amount	Percent	Amount	Percent	Amount	Percent
Revenue by Source:						
Local network service	\$ 80.2	22.9%	\$ 86.5	26.5%	\$ 91.7	30.3%
Network access	90.9	26.0	92.4	28.3	97.5	32.2
Deregulated and other revenue	21.0	6.0	23.9	7.3	22.0	7.3
Local telephone	192.1	54.9	202.8	62.0	211.2	69.8
Wireless	115.6	33.0	86.2	26.4	56.7	18.7
Internet	25.2	7.2	21.7	6.6	20.2	6.7
Interexchange	16.9	4.9	16.1	4.9	14.6	4.8
Total	\$ 349.8	100.0%	\$ 326.8	100.0%	\$ 302.7	100.0%

Local telephone

We are the largest local exchange carrier in Alaska. We provide local telephone service through our four local telephone companies. Our local telephone revenue consists of local network service, network access (including universal service revenue), and deregulated and other revenue, each of which we describe below.

Local network service

Our local network services consist of basic local network service and competitive local network service.

Basic local network service. Basic local network service enables customers to make and receive telephone calls within a defined "exchange" area. We provide basic retail local services to consumer and business customers, generally for a fixed monthly charge. The amount that can be charged to a customer for basic local services is determined by rate proceedings governed by the Regulatory Commission of Alaska ("RCA"). We generally charge business customers higher rates to recover a portion of the costs of providing local service to consumers, as is customary in the industry. Our basic local service also includes non-recurring charges to customers for installation and recurring charges for enhanced features such as call waiting, caller identification, and call forwarding.

Competitive local network service. We provide interconnection to our basic local service and lease unbundled network elements ("UNEs") to our competitors. We report revenues for these services as local network service revenues. As of November 26, 2004, the RCA authorized us to increase the Unbundled Network Element loop ("UNE-L") rate for our Anchorage service area to \$18.64 retroactively to June 2004. In the Fairbanks and Juneau service areas, the RCA authorized us to increase UNE loop rates to \$23.00 and \$18.00, respectively, as of January 1, 2005. We provided approximately 57,800 lines to competitors in the Anchorage, Fairbanks and Juneau service areas on either a wholesale or UNE basis as of December 31, 2006. Beginning on December 28, 2006, the Federal Communications Commission ("FCC") authorized us to increase our UNE loop rates on new UNE's in substantially all of the Anchorage service area to \$23.00. Effective January 1, 2008, all UNE loop rates will increase to \$23.00.

Table of Contents

The table below sets forth the number of access lines as of December 31, 2006, 2005 and 2004. The number of access lines shown represents all revenue producing access lines connected to both retail and wholesale customers.

	As of December 31,		
	2006	2005	2004
Retail access lines	194,815	199,341	206,209
Wholesale access lines	11,226	13,966	16,590
Unbundled network elements	46,626	57,578	70,954
Total local telephone access lines	<u>252,667</u>	<u>270,885</u>	<u>293,753</u>

Network access

We charge interexchange carriers for network access services for originating and terminating long distance or toll calls on our network. We also receive universal service revenue, which we report as network access revenue. We describe these components of network access revenue below.

Intrastate access charges. We generate intrastate access revenue when an intrastate long distance call carried by an interexchange carrier originates and/or terminates on one of our local telephone networks. We also provide billing and collection services for interexchange carriers through negotiated agreements for certain types of toll calls placed by our local customers. Our subsidiaries, ACS of Anchorage, Inc. ("ACSA"), ACS of Alaska, Inc. ("ACSAK") and ACS of Fairbanks, Inc. ("ACSF") operate under their own tariffs for intrastate access. In non-competitive areas, our subsidiary, ACS of the Northland, Inc. ("ACSN") participates in a mandatory statewide tariff and access charge pooling arrangement that is administered by the Alaska Exchange Carriers Association ("AECA"). The RCA regulates access charges for our intrastate services.

Interstate access charges. We generate interstate access revenue when a long distance call involving another state originates and/or terminates on one of our local telephone networks. The FCC regulates interstate access charges. All our local telephone companies, except ACSA, participate in a nationwide tariff and access charge pooling arrangement administered by the National Exchange Carrier Association ("NECA"). ACSA participates in the NECA common line tariff, but has its own interstate access tariff for traffic sensitive and special access services. We also categorize as interstate access revenue common line revenues billed to the end user for the FCC-mandated interstate charges.

Universal service revenue. We currently receive federal universal service revenue in some of our local telephone service areas. Universal service revenue supplements the amount of local service revenue we receive to ensure that basic local service rates for customers in high cost rural areas are not significantly higher than rates charged in lower cost urban and suburban areas.

Deregulated and other revenue

Deregulated and other revenues consist of billing and collection contracts, space and power rents, pay telephone service, deregulated customer premise equipment sales ("CPE"), regulated directory listing revenue, and other miscellaneous telephone revenue. We seek to capitalize on our local presence and network infrastructure by offering these additional services to customers and interexchange carriers.

Wireless

We provide statewide mobile voice and data communications services throughout Alaska. We are the only statewide provider to offer CDMA and EV-DO. We believe CDMA provides better capacity for voice and data communications than other commercial mobile technologies because it allows more subscribers to connect at any given time. Our CDMA network provides our customers with improved voice call quality, security, average mobile data speeds of 60-80kbps over 1xRTT and multiples of this over EV-DO, and other enhanced services, such as wireless email, web, digital picture taking/sending, assisted-GPS position location applications, video and audio streaming.

Table of Contents

We estimate our wireless network footprint covers approximately 542,000 or 81%, of Alaska’s approximately 670,000 residents, including all major population centers and highway and ferry corridors. Our EV-DO mobile wireless broadband service, enables high speed data connectivity with speeds that burst up to 2mbps in Anchorage, Fairbanks, Juneau, and a few other popular areas throughout Alaska. While using our EV-DO network, our customers do not need to locate a “WiFi Hot Spot” to obtain wireless broadband service. We also operate a TDMA digital network in substantially all of our service areas for our customers who have not yet upgraded to CDMA.

Our wireless segment generates revenue through subscriber access charges, airtime usage, toll charges, connection fees, roaming revenues, and enhanced features, such as short messaging services. A subscriber may purchase services separately or may purchase rate plans that package these services in different ways to fit different calling patterns and desired features.

We have eligible telecommunications carrier (“ETC”) status in a significant portion of our rural wireless service area. By obtaining ETC status, we become eligible to receive universal service funded support for wireless subscribers residing in the areas covered by this designation.

Subscribers. The table below sets forth the annual growth in the number of our wireless subscribers served and our total covered population as of December 31, 2006, 2005 and 2004.

	As of December 31,		
	2006	2005	2004
Estimated covered population	541,940	523,827	482,251
Ending subscribers	133,988	117,537	100,657
Ending penetration	24.7%	22.4%	20.9%

We believe there are opportunities to improve coverage and subscription rates of our wireless operations throughout Alaska. We also believe that the market for wireless services will continue to grow.

Licenses. We own 800 megahertz B side cellular licenses which cover the major population centers in Alaska, including Anchorage, Fairbanks, Juneau, and the Kenai Peninsula. We also own several 10 megahertz E Block PCS licenses covering the entire state including Anchorage, Fairbanks and Juneau and 10 megahertz F Block PCS licenses covering Fairbanks and Juneau.

Internet

We offer high-speed DSL service over our access lines in our major local telephone service territories. Approximately 75% of our access lines in these major local telephone service territories have the capability to provide DSL service. We also offer dial-up Internet service. We charge customers either a flat rate for unlimited use or a measured rate based on usage.

Interexchange

We currently serve approximately 64,000 long distance customers who have selected us as their preferred interexchange carrier. We believe our interexchange revenue represents less than 5% of total interexchange revenues in Alaska. We own fiber capacity for high-speed links within Alaska and for transportation of call traffic outside Alaska. We also resell the services of other long distance carriers.

Video entertainment

We partner with the DISH Network, a leading satellite television provider, to offer our customers video entertainment. Our agreement with DISH Network will terminate in December 2007 if it is not extended.

Table of Contents

Seasonality

We believe our wireless revenue is materially impacted by seasonal factors. Wireless revenue, particularly roaming revenue, declines in the winter months and increases in the summer months due to Alaska's northern latitude and the wide swing in available daylight and changes in weather patterns between summer and winter and their effect on business, tourism and subscriber calling patterns. Our other business segments experience similar seasonal effects, but we do not believe these effects are material.

Sales and Marketing

We market our products and services under the "Alaska Communications Systems" and "ACS" brands, subject to regulatory and strategic business considerations. Key components of our sales and marketing strategy include:

- establishing name recognition of the ACS brand across all product and service offerings;
- making, buying and using ACS products and services easier than ever;
- marketing all of our offerings to each consumer to obtain a greater percentage of each consumer's telecommunications services expenditures;
- providing convenient and valuable bundles of products and services;
- centralizing marketing functions to optimize impact and efficiency;
- improving quality and reliability of customer service;
- developing and delivering to the market new products and services driven by a view of total customer needs;
- driving greater productivity from direct sales efforts; and
- teaming sales and service for a complete and seamless customer experience.

We use our position as an integrated, one-stop provider of telecommunications services with strong positions in local telephone, wireless, Internet and interexchange markets. By pursuing a marketing strategy that facilitates integration, cross-selling, and packaging of our products and services, we believe we can increase penetration of new product offerings, improve customer retention rates, increase our share of our customers' overall telecommunications expenditures, and achieve continued revenue and operating cash flow growth.

Network and Technology

As of December 31, 2006, we owned host switches serving approximately 253,000 access lines. All of our access lines are served by digital switches provided predominantly by Nortel Networks Corporation. Our switches are linked through a combination of extensive aerial, underground and buried cable, including fiber-optic cable and digital microwave and satellite links. We have 100% single-party services, or services of one customer per access line, and believe substantially all of our major switches have current generic software upgrades installed which allows for the full range of enhanced customer features, such as call waiting, caller identification, and call forwarding.

We have integrated numerous network elements to offer a variety of services and applications that meet the increasingly sophisticated needs of our customers. These elements include Signal System 7 signaling networks, voice messaging platforms, digital switching, DSL and, in some communities, integrated service digital network access. As the telecommunications industry experiences significant changes in technology, customer demand and competition, we intend to introduce additional enhancements.

Technicians located at our network operating control center in Anchorage operate and monitor our wireline and wireless networks seven days a week, 24 hours a day. Our customer care call center and walk-in facilities in Anchorage and Fairbanks and additional walk-in customer care facilities in Juneau, Sitka, Kenai/Soldotna, Kodiak, North Pole and Homer sell and service all of our product lines. All of these facilities offer extended business hours to efficiently handle customer inquiries and orders for service.

Our wireless operations consist of five digital switching centers, approximately 194 cell locations, which in certain cases include multiple base stations, and three repeaters covering 80.9% of Alaska's population and substantially all major population centers and highway corridors in the state plus one analog switch and cell site covering Barrow, Alaska. We link our switching and cell site infrastructure primarily by our proprietary fiber, wireline and digital microwave connections. We have constructed and are continuing to enhance and expand our commercial wireless voice and data CDMA 1xRTT and EV-DO networks. Our CDMA network consists of two Nortel digital CDMA switches and 172 cell sites as of December 2006. We also operate a

Table of Contents

TDMA network for our customers who have not yet upgraded to CDMA. Our TDMA wireless voice network consists of three Ericsson digital switches, one analog switch serving Barrow, Alaska, and approximately 105 base stations using our 800 megahertz B side cellular licenses. Our TDMA network covers the major population centers in Alaska, including Anchorage, Fairbanks, Juneau and the Kenai Peninsula. We plan to continue to expand our CDMA 1xRTT and EV-DO networks and migrate our TDMA subscribers onto our CDMA network. Our CDMA network was initially deployed using our 10 megahertz E and F Block PCS spectrum, but we expect to eventually deploy CDMA technology over our 800 megahertz B side cellular licenses and phase out TDMA service in the future.

Our facilities-based long distance network connects the major population center of Anchorage, Fairbanks, Juneau and the Kenai Peninsula to each other primarily over owned fiber-optic facilities or Indefeasible Rights of Use ("IRU") capacity. We own IRU fiber-optic capacity connecting Alaska to the rest of the world via Seattle, Washington.

Competition

Local telephone service

Our local telephone services operations may be subject to any of several types of competition:

- facilities-based competition from providers with their own local service network;
- resale competition from resale interconnection, or providers who purchase local service from us at wholesale rates and resell these services to their customers;
- competition from UNE interconnection, that is, providers who lease UNEs from us; and
- alternatives to local service networks, including wireless, IP, satellite and cable telephony.

In September 1997, GCI and AT&T Alascom, the two largest long distance carriers in Alaska, began providing competitive local telephone services in Anchorage. GCI competes principally through UNE interconnection using the facilities of our local telephone subsidiary, ACSA, and increasingly over its own facilities. AT&T Alascom competes primarily by reselling ACSA's services. Competition is based upon price and pricing plans, types of services offered, customer service, billing services, and quality and reliability of service. GCI has focused principally on advertising discount plans for bundled services. AT&T Alascom's strategy has been to resell ACSA's service as part of a package of local and long distance services. As a result, in Anchorage, ACSA had only approximately 48% competitive market share as of December 31, 2006. We expect GCI and AT&T Alascom to continue to compete with us for local telephone business in many of our markets.

As of December 31, 2006, we estimate that we had approximately 68% market share in Fairbanks. GCI has competed in Fairbanks primarily through reselling services and through UNE interconnection. Similar trends are being experienced by ACSAK in our Juneau market where, as of December 31, 2006, we had approximately 60% market share.

We expect increasing competition from providers of various services that bypass our network. Long distance companies may construct, modify, or lease facilities to transmit traffic directly from a user to a long distance company. Cable television companies may modify their networks to partially or completely bypass our local network. GCI commenced deployment of cable telephony in 2004 and continues to migrate its customers served using our UNEs off of our network and onto its own cable system. This migration of our network will result in a significant reduction of revenue for us, as GCI would no longer be leasing our facilities to serve those customers.

In addition, while wireless telephone services have historically complemented traditional local exchange carrier ("LEC") services, we anticipate that existing and emerging wireless technologies may increasingly compete with LEC services. For example, we have deployed CDMA 1xRTT and EV-DO wireless services in certain of our markets. Our principal wireless competitor, Dobson, is deploying GSM wireless services. Both CDMA and GSM technologies may serve as a satisfactory wireless alternative to traditional LEC wireline services. At this time we cannot predict the impact of the growth in wireless networks on our share of the local market. Technological developments in wireless telephone features, digital microwave, and other wireless technologies are expected to further permit the development of alternatives to traditional wireline services. Further, the FCC's requirement that incumbent local exchange carriers ("ILECs"), such as us, offer wireline-to-wireless number portability may also increase the competition ILEC companies face from wireless carriers.

Table of Contents

Wireless services

The wireless telecommunications industry has experienced rapid technological change, an increasing pace of improvements in the capacity and quality of digital technology, shorter cycles for new products and enhancements, and changes in consumer preferences and expectations. We believe that demand for wireless telecommunications services will likely increase as equipment costs and service rates continue to decline and equipment becomes more convenient and functional. Wireless providers compete over price, quality, network coverage, packaging features, and brand reputation. There are six PCS licensees in each of our wireless service areas. We hold B side cellular licenses for Alaska's major communities and PCS licenses covering the entire state, including Anchorage, Fairbanks, Juneau, and the Kenai Peninsula. We currently compete with at least one other facilities-based wireless provider in each of our wireless service areas, including Dobson and Alaska DigiTel, LLC ("Alaska DigiTel"). We also face competition from GCI, which is a branded reseller of Dobson. In addition, Dobson, our main wireless competitor, also provides some coverage on its own network in multiple states outside Alaska. We believe that the unique and vast terrain and the high cost of a PCS system build-out, however, make additional competitive entry into markets outside of Anchorage difficult.

Competition, for simpler wireless voice service has forced carriers such as us to reduce prices. We seek to offset this impact by bringing new higher-margin services to market, developing products for targeted market segments, and using our advantage in market share and geographical coverage to attract new customers and offer new services to existing customers. We continuously evaluate new services in order to differentiate us from our competitors, produce additional revenues, and increase margins.

Internet services

We offer DSL services in Anchorage, Fairbanks, Juneau, Kenai/Soldotna, Homer, Kodiak, and Sitka, Alaska for both consumers and businesses. The market for Internet access services is highly competitive in most markets in the state. Few significant barriers restrict entry into the market, and we expect that competition will intensify in the future. We primarily compete with GCI in the market for Internet access services.

In addition to GCI, we currently compete with a number of established online services companies, interexchange carriers, and cable television operators. Competition is particularly intense for broadband services. The number of cable modems deployed by GCI is approximately two times the number of DSL modems deployed by us. Further, the addition of wireless broadband to the mix of options available to consumers may reduce the demand for DSL. We believe that our ability to compete successfully will depend upon a number of factors, including the reliability and security of our network infrastructure, the ease of access to the Internet, particularly broadband access, and our competitors' prices.

Interexchange services

The long distance telecommunications market is highly competitive. We believe we currently have less than 5% of total interexchange revenues in Alaska. Competition in the long distance market is primarily on price, although service bundling, branding, customer service, billing services, and quality also play a role in customers' choices. We currently offer long distance service to customers located primarily in the more populated communities within our service territory. AT&T Alascom and GCI are currently the two major competing long distance providers in Alaska. We also face competition from wireless service providers for long distance customers. In addition, new carriers offering voice over Internet protocol services may lead to a reduction in traditional long distance telephone service customers. Further, we also compete with prepaid calling cards that reduce traditional reliance on long distance telephone service and also deprive us of revenue obtained from the use of our interexchange facilities. We provide traditional "1+" direct long distance dialing, toll-free services, calling cards, and private line services for data and voice applications. We have also introduced flat-fee long distance programs. These programs allow customers to purchase interstate minutes of use in blocks of time for a single monthly fee. We expect to continue offering products of this nature in the future.

Video entertainment

We resell the DISH Network in Alaska. DISH Network's primary competitor is GCI, the cable provider in most of Alaska. GCI holds a dominant position in the video entertainment sector. Our current agreement with DISH Network became effective August 2003 and either will be renegotiated or will terminate in December 2007.

Table of Contents

Employees

As of January 31, 2007, we employed approximately 986 regular full-time employees, 7 regular part time employees and 8 full time temporary employees. 78.3% of our employees are represented by the International Brotherhood of Electrical Workers, Local 1547 ("IBEW"). Management considers employee relations to be good with both the represented and non-represented workforce. On November 2, 1999, the IBEW membership for our company ratified the terms of a Master Collective Bargaining Agreement that governs the terms and conditions of employment for all IBEW represented employees working for us in the State of Alaska. The November 1999 agreement, which was due to expire on December 31, 2006, provided for wage increases up to 4% in specified years based on the annual increases in the consumer price index for Anchorage as reported by the U.S. Department of Labor CPI-U. The agreement limits the increases in our health and welfare contributions for represented employees to 4% annually. On February 23, 2005, the membership of the IBEW ratified an extension to the collective bargaining agreement through 2009 and accepted certain modifications to the agreement.

Non-represented employees qualify for wage increases based on individual and company performance, and key employees are also eligible for performance-based incentives. We provide a total benefits package, including health, welfare, and retirement components that we believe is competitive in our market.

Website Access to Reports

Our investor relations website Internet address is www.alsk.com. The information on our website is not incorporated by reference in this annual report on Form 10-K. We make available, free of charge, on our investor relations website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act. These reports are available as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.

Regulation

The following summary of the regulatory environment in which our business operates does not describe all present and proposed federal, state and local legislation and regulations affecting the telecommunications industry in Alaska. Some legislation and regulations are currently the subject of judicial review, legislative hearings and administrative proposals which could change the manner in which this industry operates. We cannot predict the outcome of any of these matters or their potential impact on our business. Regulation in the telecommunications industry is subject to rapid change, and any such change may have an adverse effect on us.

Overview

The telecommunications services we provide and from which we derive a large majority of our revenue are subject to extensive federal, state and local regulation. Our LEC subsidiaries are regulated common carriers and have the right to set maximum rates at a level that allows us to recover the reasonable costs incurred in the provision of regulated telecommunications services and to earn a reasonable rate of return on the investment required to provide these services. Because they face competition, however, most of our LEC subsidiaries may not be able to realize their allowed rates of return.

In establishing rates for regulated services, our LEC subsidiaries first determine their aggregate costs and then allocate those costs between regulated and non-regulated services, then separate the regulated costs between the state and federal jurisdictions, and finally among their various interstate and intrastate services. This process is governed primarily by the FCC's rules and regulations. The FCC is considering whether to modify or eliminate the current jurisdictional separations process. This decision could indirectly increase or reduce earnings of carriers subject to jurisdictional separations rules by affecting the way regulated costs are divided between the federal and state jurisdictions, if rates in both jurisdictions are not adjusted accordingly. Maximum rates for regulated services are regulated by the FCC for interstate services and by the RCA for intrastate services.

At the federal level, the FCC generally exercises jurisdiction over services of telecommunications common carriers, such as us, that provide, originate or terminate interstate or international communications and related facilities. The FCC does not directly regulate enhanced services and has preempted inconsistent state regulation of enhanced services. Our wireless services use FCC radio-frequency licenses and are subject to various FCC regulations, including enhanced 911 ("E911") and number portability requirements. The RCA generally exercises jurisdiction over services and facilities used to provide, originate or terminate communications between points in Alaska. In addition, pursuant to the federal Telecommunications Act of 1996 ("Telecommunications Act") federal and state regulators share responsibility for implementing and enforcing policies intended to

Table of Contents

foster competition in local telecommunications services. In particular, state regulatory agencies have substantial oversight over the provision by ILECs of interconnection and non-discriminatory network access to competitive local exchange carriers ("CLECs"). Local governments often regulate the public rights-of-way necessary to install and operate networks. These local governments may require communications services providers to obtain licenses or franchises regulating their use of public rights-of-way, and may require carriers to obtain construction permits and abide by building and land use codes.

Federal regulation

We must comply with the Communications Act of 1934, as amended ("Communications Act") and regulations promulgated there under which require, among other things, that communications carriers offer interstate services at just, reasonable and nondiscriminatory rates and terms. The amendments to the Communications Act contained in the Telecommunications Act significantly changed and are expected to continue to change the regulation of the telecommunications industry. The Telecommunications Act promotes competition in local telecommunications services by removing barriers to entry, imposing interconnection and network access requirements, and making universal service support explicit and portable. We must obtain FCC approval before we transfer control of any of our common carrier subsidiaries or our radio frequency licenses or authorizations, make such an acquisition, or discontinue an interstate service.

Interconnection with local telephone companies and access to other facilities

In order to ensure access to local facilities and services at reasonable rates the Communications Act imposes a number of access and interconnection requirements on LECs. Generally, a LEC must: not prohibit or unreasonably restrict the resale of its services; provide for telephone number portability, so customers may keep the same telephone number if they switch service providers; ensure that customers are able to route their calls to telecommunications service providers without having to dial additional digits; provide access to their poles, ducts, conduits and rights-of-way on a reasonable, non-discriminatory basis; and, when a call originates on its network, compensate other telephone companies for terminating or transporting the call.

Most ILECs have the following additional obligations under the Communications Act: negotiate in good faith with any carrier requesting interconnection; provide interconnection for the transmission and routing of telecommunications at any technically feasible point in its network on just, reasonable and non-discriminatory rates, terms and conditions; provide access to UNEs, such as local loops, switches and trunks, or combinations of UNEs at nondiscriminatory, cost-based rates; offer retail local telephone services to resellers at discounted wholesale rates; provide notice of changes in information needed for another carrier to transmit and route services using its facilities; and provide physical collocation, which allows a CLEC to install and maintain its network termination equipment in an ILEC's central office, or to obtain functionally equivalent forms of interconnection.

Our ACSN ILEC subsidiary enjoys a statutory exemption as a rural carrier from the interconnection requirements imposed on most ILECs. The RCA may terminate the exemption, if it determines the interconnection is technically feasible, not unduly economically burdensome and consistent with universal service. The Telecommunications Act does not, however, preclude facilities-based competition, and the RCA has granted GCI, subject to certain conditions, approval to provide local exchange telephone service in the Glacier State and Sitka study areas of ACSN. New facilities-based local exchange service competition may reduce our revenues and returns.

On April 18, 2004, ACSF and ACSAK entered into a settlement agreement with GCI in which ACSF and ACSAK waived their claim to the rural exemption in exchange for GCI's agreement to pay increased UNE loop rates.

To implement the interconnection requirements of the Telecommunications Act, the FCC adopted rules requiring, among other provisions, that ILECs price UNEs based on forward-looking economic costs using the total element long-run incremental cost methodology. In February 2005 the FCC released an order eliminating the obligation of ILECs to provide access to switching as a UNE, as well as the obligation to provide the combination of UNEs known as the UNE platform ("UNE-P"). These changes did not affect the obligations of ACSF or ACSAK under their agreement with GCI, which remains in effect until January 1, 2008. Currently, the FCC is reexamining its pricing standard for UNEs and may reconsider other aspects of its rules.

In September 2005, ACSA filed a petition seeking FCC forbearance from our requirement to lease UNEs to our competitors in Anchorage at regulated rates. Also in September 2005, the FCC established precedent for granting relief similar to that sought by ACSA by granting forbearance relief to Qwest in its Omaha market due to substantial inter-modal competition in that market. On December 28, 2006, the FCC conditionally and partially granted ACSA forbearance from the obligation to lease UNEs to our competitors at regulated rates. This forbearance was limited to five wire centers within the Anchorage service area of ACSA. Even where relief was granted, however, the FCC has required ACS to lease loops

Table of Contents

and sub-loops at commercially negotiated rates, or if there is no commercial agreement, at the rates for these UNEs in Fairbanks. A one-year transition period was part of the FCC's Order. On February 9, 2007, ACSA and GCI independently filed appeals of the FCC's Order.

Congress may consider legislation that may further modify the Communications Act and the FCC and the RCA frequently considers modifications of their rules. We cannot predict the outcome of any such of any action taken by the Congress, the FCC or the RCA.

Interstate access charges

The FCC regulates the prices that ILECs charge for the use of their local telephone facilities in originating or terminating interstate transmissions. Our ILECs' interstate "access charges" are developed using a cost-of-service methodology, based on our authorized maximum rate of return. NECA develops averaged access rates for participating ILECs, including our ILECs, based on the costs of these carriers. All our ILECs participate in NECA's tariff for non-traffic sensitive costs, which are primarily loop costs. While ACSA files its own traffic sensitive access tariff, which covers primarily switching costs, our other ILECs participate in NECA's traffic sensitive access tariff. Participants in a NECA tariff charge averaged access rates, pool their revenues, and distribute the revenues on the basis of each individual carrier's costs. The NECA tariffs reduce the cost burden on individual ILECs of filing tariffs and also spread some of the risks of providing interstate access services. None of our ILECs has chosen the FCC's price cap method for its interstate access charges.

In 2001, the FCC adopted an order implementing certain proposals of the Multi-Association Group ("MAG") to reform the access charge system for rural ILECs. Among other things, the MAG plan reduces usage sensitive access charges on long distance carriers and shifts a portion of cost recovery to subscriber line charges, which are paid by end users, and new explicit universal service support. The FCC also implemented a freeze on jurisdictional cost separations factors that expired in June of 2006, but the separations factor freeze was extended indefinitely in May of 2006. The FCC is currently considering various proposals for further reform. These proposals may result in the elimination of interstate and intrastate access charges paid by long distance carriers, and the requirement that carriers such as ACSA, ACSF, ACSAK and ACSN recover those interstate and intrastate costs from a combination of end-user charges and universal service support. Various groups of carriers and regulators are developing new proposals for replacements to the MAG plan to submit to the FCC. We cannot predict what changes the FCC may adopt or when they may adopt them.

Federal Universal Service Support

The Communications Act requires the FCC to establish a universal service program to ensure that affordable, quality telecommunications services are available to all Americans. The program at the federal level has several components, including one that pays support to LECs serving areas for which the costs of providing basic telephone service are higher than the national average. The Telecommunications Act requires the FCC to make universal service support explicit, expand the types of communications carriers that are required to pay universal support, and allow competitive providers including CLECs and wireless carriers to be eligible for universal service support, including where they serve customers formerly served by ILECs.

In May 2001, the FCC adopted a proposal from the Rural Task Force to reform universal service support for rural areas. As adopted, for an interim period, eligible rural carriers will continue to receive support based on a modified embedded cost mechanism. While the modified embedded cost mechanism remains in place in 2007, the FCC has indicated that, it will develop a comprehensive plan for high-cost support mechanisms for rural and non-rural carriers which may rely on forward-looking costs. In June, 2004, the Federal-State Joint Board sought comment on certain reforms, such as the proper definition to use in determining whether a carrier should be supported under the "rural" mechanism (as opposed to the "non-rural" mechanism based on forward-looking costs), the basis on which support levels for rural carriers (both ILECs and CLECs) should be calculated. These issues remain pending before the Joint Board, which has not offered a definitive proposal to reform universal service support. If it does so, the FCC would have one year to act on these recommendations. In addition, members of Congress have indicated that they may seek enactment of legislation addressing universal service reform, including legislation to limit growth of explicit universal service support funds. We are unable to predict whether and to what extent we would be eligible to receive any federal high-cost support under such a plan.

Table of Contents

Universal service funds are only available to carriers that are designated as ETCs, by a state regulatory commission for carriers subject to state jurisdiction, or by the FCC, for other carriers not subject to state jurisdiction. On March 17, 2005, the FCC adopted new and more stringent guidelines concerning the designation of competitive carriers as ETCs ("CETCs") for designations that it makes under its jurisdiction. Although the new guidelines are not binding on state commissions, several parties have asked the FCC to require states to follow them on reconsideration. The RCA has commenced a state rulemaking proceeding to consider possible changes prompted by the FCC guidelines. We do not anticipate any impact on the eligibility of our ILECs to receive universal service support as a result of these rule changes.

Under current FCC regulations, the total amount of federal universal service funds available to all ILEC ETCs is subject to a yearly cap. In any year where the cap is reached, the per access line rate at which ILECs can recover Universal Service Fund payments may decrease. In each of the last few years, the cap has effectively decreased Universal Service Fund ("USF") payments.

We also expect the FCC to act in 2007 to reform the current funding mechanism for the universal service support funds. Today, our operating subsidiary companies are required to contribute to the federal USF a percentage of their revenue earned from interstate and international services. The FCC is currently considering whether to replace this funding mechanism with one based on flat-rated, per-line contributions, capacity-based contributions, or some combination of these or other proposals. We cannot predict how the outcome of this proceeding may affect our contribution obligations.

Interstate long distance services

FCC regulation of the rates, terms or facilities of our interstate long distance services is relatively light. However, we must comply with the general requirement that our charges and terms be just, reasonable and non-discriminatory. Also, we must comply with FCC rules regarding unauthorized switching of a customer's long distance service provider, or slamming; the FCC has levied substantial fines on some carriers for slamming. In addition, ACSLD must post the rates, terms and conditions of its service on its Internet web site and engage in other public disclosure activities.

The FCC required that ILECs that provide interstate long distance services originating from their local exchange service territories must have long distance affiliates which maintain separate books of account and acquire any services from their affiliated ILECs at tariff rates, terms and conditions.

On December 8, 2004, Congress enacted a new law requiring, through 2009, the purchase and sale of interstate wholesale switched service elements at rates equivalent to the rates set forth in AT&T Alascom's Tariff 11, subject to annual downward adjustments specified in the statute. Rural telephone companies, or companies that are affiliated with and under the control of rural telephone companies, are exempt from the requirement to purchase services at such rates.

Wireless services

The FCC regulates the licensing, construction, operation, acquisition and sale of personal communications services and cellular systems in the United States. All cellular and personal communications services licenses have a 10-year term, at the end of which they must be renewed. Licenses may be revoked for cause, and license renewal applications may be denied if the FCC determines that renewal would not serve the public interest. In addition, all personal communications services licensees must satisfy certain coverage requirements. Licensees that fail to meet the coverage requirements may be subject to forfeiture of the license.

Federal law preempts state and local regulation of the entry of, or the rates charged by, any provider of commercial mobile radio services ("CMRS") which includes personal communications services and cellular services. The FCC does not regulate such rates; however, the FCC imposes a variety of other regulatory requirements on CMRS operators. For example, CMRS operators must be able to transmit 911 calls from any qualified handset without credit check or validation, and are required to provide the location of the 911 caller within an increasingly narrow geographic range. CMRS operators are also required to provide 911 service for individuals with speech and hearing disabilities, or TTY service. The FCC granted ACS a waiver allowing a limited extension of time to comply with the FCC's E911 requirements: (1) that all new handset activations are location-capable; and (2) that 95% of all subscribers have location-capable handsets. Consistent with the FCC's order, all new ACS Wireless, Inc. ("ACSW") handset activations have been location-capable since January 1, 2006. Further, ACSW met the FCC's deadline of having 95% of all subscribers using location-capable handsets prior to January 31, 2007.

Table of Contents

FCC regulations also require us to maintain our analog network operations as we transition to our new CDMA wireless network. In December 2006, the FCC granted ACSW a limited waiver of that requirement, allowing ACSW to turn down seven remote and very high cost analog cell sites.

The FCC also requires that if a LEC customer wants to retain a telephone number while changing to a CMRS service provider (such as ACSW), the LEC must have the capability to allow this wireline-to-wireless number portability within six months of a bona fide request, where the requesting CMRS carrier's coverage area overlaps the geographic location of the LEC rate center to which the number is assigned (unless the LEC can provide specific evidence demonstrating that doing so is not technically feasible). These number portability rules are expected to increase the level of competition among CMRS service providers, but also to increase the ability of CMRS providers to win customers from LECs. This rule has had little impact on our LECs, but we cannot predict the net impact of these new rules on us over the long-term.

Internet services

We provide Internet access services as an Internet service provider ("ISP"). The FCC has classified such services as information services, so they are not subject to various regulatory obligations that are imposed on common carriers, such as paying access charges or contributing to USF. On September 23, 2005, the FCC announced a policy of ensuring neutral access to and operation of the Internet. SBC and Verizon, the two largest ILECs, have agreed to conduct their businesses in compliance with the FCC policy as a condition of the FCC's approval of their acquisitions of AT&T and MCI, respectively. There may be new legislation or further FCC action to address access to the Internet, and we cannot predict the impact of any such actions on our results or operations. Also, the FCC generally preempts state and local regulation of information services.

In October 2005, the FCC determined that ILECs are no longer required to lease high-speed Internet access service transmission capability to their competitors, and re-affirmed its finding that provision of high-speed transmission service bundled with Internet access services is an information service not subject to common carrier regulation, whether that access is provided via cable modem, DSL services, or otherwise. This decision gives us more flexibility in how we offer and price our DSL services. However, for carriers subject to rate-of-return regulation, like the ACS ILECs, the FCC left uncertain whether loop cost allocations would change if they decide to offer the underlying transmission capability on a non-common carrier basis. We currently provide high-speed Internet access transmission capability on a common carrier basis under a stand-alone FCC tariff for ACSA and the NECA tariff for our non-Anchorage LECs. We are considering whether to offer it as non-common carrier service.

In February 2004, the FCC determined that entirely Internet-based voice over Internet Protocol ("VoIP") service is an information service and exempt from such regulatory obligations. This finding applied only to VoIP services that do not connect to the public (circuit) switched telephone network. Also in February 2004, the FCC launched a comprehensive rulemaking to determine the appropriate types of regulation, including such matters as intercarrier compensation and contributions to USF, to which ISPs offering or enabling different types of IP services, including VoIP, should be subject. In November 2004, the FCC decided that some VoIP services are exempt from certain state regulations. While VoIP services and high-speed Internet access services generally are not subject to common carrier regulation, the FCC has determined in recent decisions that these services are subject to certain public safety requirements. For example, in May 2005, the FCC found that 911 requirements apply to VoIP. Further, in August 2005, the FCC found that the Communications Assistance for Law Enforcement Act ("CALEA") requires providers of both high-speed Internet access services and some VoIP services to ensure that their networks have certain capabilities that facilitate the conduct of electronic surveillance by law enforcement agencies. The FCC has required ISPs including ACSI to be capable of CALEA compliance by May 2007, but we cannot be certain ACSI will meet this deadline. The FCC has also determined that a component of VoIP revenues is subject to USF contributions. Where VoIP providers are unable to specifically identify their interstate traffic, a "safe harbor" factor is applied.

Other federal regulations

We are subject to various other federal regulations and statutes, including those concerning the use of customer proprietary network information ("CPNI") in marketing services, and implementing capabilities to be used by law enforcement officials in executing court authorized electronic surveillance. CPNI generally includes information a carrier has regarding the telecommunications services to which its customer subscribes and the customer's use of those services. In February, 2006, the FCC initiated a rulemaking to determine if it should strengthen its rules governing carrier use and

Table of Contents

disclosure of CPNI. Other FCC initiatives that may impact our regulated subsidiaries include access to poles, ducts, conduits and rights-of-way, Truth-in-Billing requirements, EEO reporting, hearing aid compatibility requirements, and anti-slamming rules. These requirements may impose costs on us and limit our business opportunities.

State regulation

Telecommunication companies are required to obtain certificates of public convenience and necessity from the RCA prior to operating as a public utility in Alaska. The RCA must approve amendments to and transfers of such certificates. In addition, RCA approval is required if an entity acquires a controlling interest in any of our certificated subsidiaries, if we acquire a controlling interest in another intrastate utility, or if we discontinue an intrastate service. The RCA also regulates rates, terms and conditions for local, intrastate access and intrastate long distance services, supervises the administration of the Alaska Universal Service Fund ("AUSF") and decides on ETC status for purposes of the federal USF. Furthermore, pursuant to the Telecommunications Act and the FCC's rules, the RCA decides various aspects of local network interconnection offerings and agreements.

Interconnection

The Telecommunications Act specifies that resale and UNE rates are to be negotiated among the parties subject to approval by the state regulatory commission, or, if the parties fail to reach an agreement, arbitrated by the state regulatory commission. We have entered into interconnection agreements with TelAlaska Long Distance, Inc., Level 3, and numerous other entities, including GCI.

On January 7, 2005, GCI filed suit in federal court seeking reversal of the RCA's 2004 order approving the interconnection agreement between GCI and ACSA. GCI claims that the pricing methodology the RCA used to determine the rates we charge GCI under the interconnection agreement did not comply with the FCC's pricing methodology regulations and requests the court direct the RCA to retroactively reduce the rates we charge GCI under this agreement. ACSA also challenged the RCA's decision, in part, asserting that the RCA unreasonably delayed reaching a final, legal UNE loop rate, that the temporary UNE loop rate set by the RCA did not comply with federal law, and that the RCA's decision regarding the percentage of feeder plant that must be placed in the road prism was not supported by substantial evidence. In November 2006, the court ruled against all claims and upheld the RCA's decision.

Competitive local exchange regulations

In August 2005, the RCA adopted regulations addressing a variety of telecommunications related matters including tariff policies, depreciation practices, local competitive market rules, and interexchange competitive market rules. The regulations provide for, among other things: initial classification of all ILECs, including our rural properties and ACSA, as dominant carriers; requirements that all carriers, both dominant and non-dominant, offer all retail services for resale at wholesale rates consistent with 47 U.S.C. § 251 and 252; and limited dominant carrier pricing flexibility in competitive areas, under which carriers may reduce retail rates, offer new or repackaged services and implement special contracts for retail service upon 30 days' notice. Rate increases affecting existing services are subject to full cost support showings by the dominant carrier in areas with local competition; but the RCA may demand, and has demanded, cost support even for rate reductions and new or repackaged services in competitive areas. On September 16, 2005, the RCA defined the ACSA, ACSAK and ACSF service areas as "competitive local exchange markets" under its new regulations. The RCA had previously granted ACSA, ACSAK and ACSF non-dominant status on a trial basis only for retail tariff purposes. On February 22, 2006, the RCA designated ACSA, ACSAK-Juneau and ACSF as non-dominant carriers in their respective competitive local exchange markets for the provision of retail services except for line extension services, construction services, subdivision agreements and access services. This change in designation has given these three ACS LECs access to relaxed tariff filing rules that allow retail offers to be introduced to the market without advance public notice or RCA approval. We are seeking similar designation changes for ACSN and the second study area in ACSAK to become immediately effective upon receipt of a CLEC's 90-day notice of intent to enter these markets.

End user local rates

The rates charged by our ILECs to end-users for basic local service are generally subject to the RCA's regulation based on a cost-of-service method using an authorized rate of return. Competition may prevent local rates from being sufficient to recover embedded costs for local service. Rate cases are typically infrequent, carrier-initiated and require the

Table of Contents

carrier to meet substantial burdens of proof. The RCA may, however, investigate, upon complaint or upon its own motion, the rates of a LEC and hold hearings on those rates.

Intrastate access rates

ILECs not yet subject to local competition participate in a pool administered by AECA for intrastate access charges to long distance carriers. AECA pools their access costs and sets a statewide average price which participating ILECs charge to long distance carriers for originating or terminating calls. Access revenues are collected in a pool and then redistributed to the ILECs based on their actual costs.

The RCA requires an ILEC to file separate, individual company access charge tariffs when a competitor enters its service area. These tariffs are based on the ILEC's cost of service and are revised biennially. ACSN is our only ILEC associated with AECA. AECA administers ACSN's intrastate access tariff, but ACSN has a stand-alone rate. In 2006, the RCA commenced a state rulemaking proceeding to consider the impact of competition on the access pooling process and whether to continue to require ILECs in competitive markets to exit the AECA pool.

The RCA has adopted regulations limiting the access fees local carriers can charge interexchange carriers and imposing a Network Access Fee on end-users to make up for the reduction in fees paid by interexchange carriers. The RCA is also analyzing the effects of various FCC intercarrier compensation proposals on Alaskan consumers and telecommunications companies.

Alaska Universal Service Fund

The RCA has established the AUSF. The AUSF serves as a complement to the federal USF, but must meet federal statutory criteria concerning consistency with federal rules and regulations. Currently, the AUSF supports a portion of certain higher cost carriers' switching costs, the costs of lifeline service (which supports rates of low income customers), and a portion of the cost of Public Interest Pay Telephones. The RCA has adopted regulations that limit high-cost switching support to local companies with access lines of 20,000 or less. This change has eliminated the switching support that our rural ILECs received.

ETC Determinations

The RCA granted GCI's request that it be designated an ETC in Anchorage, Fairbanks, Juneau, and Fort Wainwright, all of which are currently served by our subsidiaries. Further, there is a trend toward granting ETC status to wireless carriers. In July 2004, ACSW was granted ETC status in the MTA and ACSF study area and was subsequently ETC status in ACSA, ACSAK-Juneau, and ACSN-Glacier State study areas in November 2004. ACSW was also granted ETC status in the areas serviced by the Copper Valley Telephone Cooperative, Inc., and KPU Telecommunications in April, 2006.

Other state regulations

The RCA adopted regulations allowing some bundling of local exchange and intrastate interexchange services. Other RCA rules, however, result in limitations on our ability to actually bundle our intrastate interexchange services.

The RCA has also opened dockets in 2005 to consider: the need to promulgate regulations to establish an affordability benchmark for local exchange telephone service, and to address whether and how to use state universal service funds to offset potentially unaffordable local exchange rates; the need to promulgate ETC regulations; and generally accepted industry standards for E911 service. All of these dockets, as well as the 2006 rulemakings previously mentioned, could impact our business.

Item 1A. Risk Factors

We face a variety of risks that may affect our business, financial condition, and results of operations, some of which are beyond our control. The risks described below are not the only ones we face and should be considered in addition to the other cautionary statements and risks described elsewhere, and the other information contained, in this report and in our other filings with the SEC, including our subsequent reports on Forms 10-Q and 8-K. Additional risks and uncertainties not known to us or that we currently deem immaterial may also affect our business. If any of these known or unknown risks or uncertainties actually occurs, our business, financial condition and results of operations could be seriously harmed.

Table of Contents

Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

Operating Revenue

Operating revenue increased \$23.0 million, or 7.0%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. Wireless, Internet and interexchange revenue increased compared to the corresponding period of 2005, while local telephone revenue decreased compared to the corresponding period of 2005.

Local Telephone. Local telephone revenue, which consists of local network service, network access and deregulated and other revenue, decreased \$10.8 million, or 5.3%, for year ended December 31, 2006 compared to the same period in 2005. The following table summarizes our consolidated local telephone revenue by category:

	<u>Year Ended December 31,</u>	
	<u>2006</u>	<u>2005</u>
	(in thousands)	
Local telephone revenue:		
Local network service	\$ 80,177	\$ 86,482
Network access	90,894	92,379
Deregulated and other	<u>20,987</u>	<u>23,981</u>
Total local telephone revenue	<u>\$192,058</u>	<u>\$202,842</u>

The following table summarizes our local telephone access lines:

	<u>As of December 31,</u>	
	<u>2006</u>	<u>2005</u>
Retail access lines	194,815	199,341
Wholesale access lines	11,226	13,966
Unbundled network elements — loop (UNE-L)	39,568	50,875
Unbundled network elements — platform (UNE-P)	<u>7,058</u>	<u>6,703</u>
Total local telephone access lines	<u>252,667</u>	<u>270,885</u>

Local network service revenue decreased \$6.3 million or 7.3% for the year ended December 31, 2006, compared to the year ended December 31, 2005. Access lines in service decreased 6.7% to 252,667, primarily reflecting the net effect of access line losses offset by increases in UNE rates and improved line mix. In November 2004 we received a final order from the RCA with respect to UNE-L rates for Anchorage, retroactive to June 2004, increasing the UNE-L rate from \$14.92 to \$18.64, and on January 1, 2005, rates increased for UNE-P and UNE-L in Fairbanks and Juneau from \$19.19 to \$23.00 and from \$16.71 to \$18.00, respectively.

Network access revenue decreased \$1.5 million, 1.6%, for the year ended December 31, 2006, compared to the same period in 2005. Network access revenue is based on a regulated return on rate base and recovery of allowable expenses associated with the origination and termination of toll calls for our retail and resale customers. The decrease was primarily attributable to the decline in depreciation expense on the LECs and its effect on the interstate access and universal service fund studies. The decreases were offset in part by a \$1.5 million settlement with interexchange carriers in the fourth quarter of 2006. We expect that network access revenue will decline as a component of local telephone revenue for the foreseeable future.

Deregulated and other revenue consists principally of billing and collection services, space and power rents, CPE, paystation revenue, regulated directory listing revenue, and other miscellaneous telephone revenue. Deregulated revenue decreased \$3.0 million, or 12.5% for the year ended December 31, 2006, compared to the year ended December 31, 2005, as the result of a decrease in CPE sales and a decline in billing and collection revenue due to amended affiliate contracts.

Table of Contents

Consistent with the U.S. telecommunications industry trend, we experienced a loss of local telephone access lines as customers migrated to broadband Internet services reducing demand for second lines, migrated to cable telephony, or replaced landline service with wireless service. During 2004, our primary competitor began deploying cable telephony and switching its UNE-L provisioned subscribers over to its own network.

Wireless. Wireless revenue increased \$29.3 million, or 34.0%, to \$115.6 million for the year ended December 31, 2006 from \$86.2 million for the year ended December 31, 2005. This increase is due primarily to the following:

- growth in subscribers year over year of 14.0% at December 31, 2006;
- an increase in average revenue per unit ("ARPU"), of 7.8% to \$58.71 for the year ended December 31, 2006, from \$54.45 for the year ended December 31, 2005, primarily as a result of improved subscriber mix with a higher proportion of post paid retail subscribers, increased plan revenue, feature revenue, roaming revenue, regulatory surcharges and receipt of CETC funding which added \$9.49 and \$7.33 to cellular ARPU in 2006 and 2005, respectively;
- higher revenue from non-ACS customers roaming on our network resulting in third-party roaming revenue increasing to \$14.2 million from \$6.7 million for the year ended December 31, 2006 and 2005, respectively.
- \$2.4 million in out of period CETC funds received in the fourth quarter of 2006; and
- higher gross customer adds, handset upgrades and accessory sales in the year ended December 31, 2006 resulting in \$8.2 million of revenue compared to \$7.1 million for the year ended December 31, 2005.

Internet. Internet revenue increased \$3.5 million, or 16.4%, for the year ended December 31, 2006 compared to the year ended December 31, 2005, primarily as a result of growth in sales of data services to commercial and government customers and DSL subscribers, which increased by 22.9% to 44,066 at December 31, 2006 from 35,884 at December 31, 2005, offset in part by a 27.6% reduction in dial-up subscribers to 12,591 at December 31, 2006.

Interexchange. Interexchange revenue increased \$0.9 million, or 5.6%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. Long distance subscribers increased 13.6% to 63,995 at December 31, 2006, from 56,317 at December 31, 2005 and annual minutes of use increased to 236.5 million for the year ended December 31, 2006, from 182.1 million for the year ended December 31, 2005. Minutes of use includes 117.4 million at December 31, 2006 compared to 65.4 million at December 31, 2005 of activity generated on our wireless network, with associated revenues recorded in our wireless segment.

Operating Expense

Operating expense decreased \$0.9 million, or 0.3%, to \$298.8 million for the year ended December 31, 2006, from \$299.7 million for the year ended December 31, 2005. Depreciation and amortization associated with the operation of each of our segments has been included in total depreciation and amortization.

Local Telephone. The components of local telephone expense are plant specific operations, plant non-specific operations, customer operations, corporate operations and property and other operating tax expense. Local telephone expense increased \$3.2 million to \$130.2 million for the year ended December 31, 2006 from \$127.0 million for the year ended December 31, 2005. The increase in local telephone expense was the result of a number of factors. The increase in local telephone expense was substantially attributable to a \$3.4 million increase in stock compensation expense and \$2.4 million increase in labor costs primarily driven by higher incentive compensation. These expenses were offset by \$1.1 million decrease in cost of goods sold related to sales of large E-911 systems in 2005 and by \$1.4 million in IT and accounting, consulting and outside service fees for SOx compliance and audit work.

Wireless. Wireless expense increased \$12.6 million, or 25.5%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. The increase in total subscribers and the continued TDMA to CDMA conversion resulted in an increase of \$3.7 million in handset, accessory and data content expense. As of December 31, 2006, 94% of our retail customer base resided on our CDMA network. The network build-out resulted in \$6.1 million of additional expense. Advertising increased \$1.3 million and we experienced an increase in regulatory charges and outsourced billing and provisioning costs of \$1.6 million, directly associated with an increase in subscribers and end user revenue.

Table of Contents

Internet. Internet expense increased by \$6.3 million, or 27.2% to \$29.6 million for the year ended December 31, 2006, compared to \$23.3 million for the year ended December 31, 2005. Consistent with the growth in DSL subscriber base, we saw an increase of \$3.8 million in DSL cost of goods sold and \$0.6 million in ISP access and circuit expenses. We also experienced a \$2.1 million increase in labor expense driven by customer service related functions supporting our DSL products and the exercise of our option to assume ownership of a fiber-optic cable running from Fairbanks to Whittier via Anchorage.

Interexchange. Interexchange expenses decreased by \$4.7 million, or 27.0% to \$12.6 million for the year ended December 31, 2006, compared to \$17.3 million for the year ended December 31, 2005. The decline is attributable to the receipt of \$1.0 million in prior year access charge credits; a \$0.4 million reduction in federal universal service surcharges; and a \$4.7 million reduction in affiliate billing and collection expense, offset in part by an increase of \$0.6 million in labor expenses; and a \$1.0 million increase in interstate traffic usage charges associated with an increase in both rates and minutes of use.

Depreciation and amortization. Depreciation and amortization expense decreased \$19.6 million, or 23.6%, for the year ended December 31, 2006 compared to the year ended December 31, 2005. The decrease is primarily attributable to certain asset classes reaching their maximum depreciable lives.

Interest expense. As a result of our debt restructuring activities, interest expense decreased by \$4.8 million to \$31.1 million for the year ended December 31, 2006 compared to \$35.9 million for the year ended December 31, 2005.

Loss on extinguishment of debt. Loss on extinguishment of debt charges arose from various accretive debt restructuring transactions. Tender premiums were \$6.4 million in 2006 compared to \$18.3 million in 2005 and the write off of unamortized debt issuance costs and settlement of original issue discounts were \$3.3 million in 2006 compared to \$16.6 million in the same period last year.

Other. In 2006, we recognized a gain of \$6.7 million following the liquidation of our stock holding in the Rural Telephone Bank ("RTB"), and a gain of \$2.0 million arising from the settlement of our transaction to acquire the Crest Communications, LLC's Alaska terrestrial fiber network. See "Note 21 — Other Events" for more information on these transactions.

Income Taxes

In 2006, we generated taxable income which was offset by net operating loss carry forwards. We did, however, incur an alternative minimum tax charge of \$0.4 million.

Net income

The increase in net income is primarily a result of the factors discussed above.

Year Ended December 31, 2005 Compared to Year Ended December 31, 2004

Operating Revenue

Operating revenue increased \$24.1 million, or 8.0%, for the year ended December 31, 2005 compared to the year ended December 31, 2004. Wireless, Internet and interexchange revenue increased compared to the corresponding period of 2004, while local telephone revenue decreased compared to the corresponding period of 2004.

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Consolidated Balance Sheets
December 31, 2006 and 2005
(In Thousands, Except Per Share Amounts)

	December 31, 2006	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	\$ 36,860	\$ 28,877
Restricted cash	1,700	4,415
Short-term investments	—	10,525
Accounts receivable-trade, net of allowance of \$7,434 and \$6,206	39,801	41,080
Materials and supplies	7,977	7,885
Prepayments and other current assets	3,514	3,445
Total current assets	89,852	96,227
Property, plant and equipment	1,164,450	1,116,780
Less: accumulated depreciation	767,907	718,750
Property, plant and equipment, net	396,543	398,030
Goodwill	38,403	38,403
Intangible assets	21,604	21,688
Debt issuance cost	9,437	11,733
Deferred charges and other assets	6,482	10,332
Total assets	\$ 562,321	\$ 576,413
Liabilities and Stockholders' Equity (Deficit)		
Current liabilities:		
Current portion of long-term obligations	\$ 1,025	\$ 683
Accounts payable — affiliates	2,942	2,844
Accounts payable, accrued and other current liabilities	62,307	54,920
Advance billings and customer deposits	10,667	9,712
Total current liabilities	76,941	68,159
Long-term obligations, net of current portion	437,188	444,895
Other deferred credits and long-term liabilities	72,881	82,223
Total liabilities	587,010	595,277
Stockholders' equity (deficit):		
Common stock, \$.01 par value; 145,000 authorized, 42,322 and 46,230 issued and 42,322 and 41,681 outstanding, respectively	423	462
Treasury stock, 0 and 4,549 shares at cost	—	(18,443)
Additional paid in capital in excess of par	288,055	333,522
Accumulated deficit	(314,733)	(334,727)
Accumulated other comprehensive income	1,566	322
Total stockholders' equity (deficit)	(24,689)	(18,864)
Commitments and contingencies		
Total liabilities and stockholders' equity (deficit)	\$ 562,321	\$ 576,413

See Notes to Consolidated Financial Statements

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Consolidated Statements of Operations
Years Ended December 31, 2006, 2005 and 2004
(In Thousands, Except Per Share Amounts)

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Operating revenues:			
Local telephone	\$192,058	\$202,842	\$211,187
Wireless	115,584	86,235	56,694
Internet	25,221	21,672	20,173
Interexchange	16,954	16,060	14,653
Total operating revenues	<u>349,817</u>	<u>326,809</u>	<u>302,707</u>
Operating expenses:			
Local telephone (exclusive of depreciation and amortization)	130,178	126,982	127,918
Wireless (exclusive of depreciation and amortization)	62,022	49,407	37,918
Internet (exclusive of depreciation and amortization)	29,625	23,298	25,739
Interexchange (exclusive of depreciation and amortization)	12,633	17,314	19,773
Depreciation and amortization	63,259	82,819	78,387
Loss (gain) on disposal of assets, net	1,105	(152)	2,854
Total operating expenses	<u>298,822</u>	<u>299,668</u>	<u>292,589</u>
Operating income	50,995	27,141	10,118
Other income and expense:			
Interest expense	(31,103)	(35,894)	(47,641)
Loss on extinguishment of debt	(9,650)	(34,882)	(3,423)
Interest income	1,835	2,253	1,633
Other	8,360	(253)	(200)
Total other income and expense	<u>(30,558)</u>	<u>(68,776)</u>	<u>(49,631)</u>
Income (loss) before income tax benefit	20,437	(41,635)	(39,513)
Income tax benefit (expense)	<u>(443)</u>	<u>—</u>	<u>219</u>
Net income (loss)	<u>\$ 19,994</u>	<u>\$ (41,635)</u>	<u>\$ (39,294)</u>
Net income (loss) per share:			
Basic	<u>\$ 0.48</u>	<u>\$ (1.04)</u>	<u>\$ (1.33)</u>
Diluted	<u>\$ 0.46</u>	<u>\$ (1.04)</u>	<u>\$ (1.33)</u>
Weighted average shares outstanding			
Basic	<u>42,045</u>	<u>40,185</u>	<u>29,592</u>
Diluted	<u>43,387</u>	<u>40,185</u>	<u>29,592</u>

See Notes to Consolidated Financial Statements

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Consolidated Statements of Stockholders' Equity (Deficit)
and Comprehensive Income (Loss)
Years Ended December 31, 2006, 2005 and 2004
(In Thousands, Except Per Share Amounts)

	Common Stock	Shares Subject to Mandatory Redemption	Treasury Stock	Additional Paid in Capital in Excess of Par	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Stockholders' Equity (Deficit)
Balance, January 1, 2004	\$ 336	\$ (1,198)	\$(17,118)	\$ 278,181	\$ (253,798)	\$ (4,543)	\$ 1,860
Components of comprehensive loss:							
Net loss	—	—	—	—	(39,294)	—	(39,294)
Minimum pension liability adjustment	—	—	—	—	—	12	12
Total comprehensive loss							(39,282)
Purchase of 267 shares subject to mandatory redemption	—	1,198	(1,262)	—	—	—	(64)
Purchase of 14 shares of common stock, \$.01 par	—	—	(63)	—	—	—	(63)
Dividends declared	—	—	—	(5,694)	—	—	(5,694)
Issuance of 1,634 shares of common stock, pursuant to stock plans, \$.01 par	16	—	—	9,785	—	—	9,801
Balance, December 31, 2004	352	—	(18,443)	282,272	(293,092)	(4,531)	(33,442)
Components of comprehensive loss:							
Net loss	—	—	—	—	(41,635)	—	(41,635)
Minimum pension liability adjustment	—	—	—	—	—	109	109
Interest rate swap marked to market	—	—	—	—	—	4,744	4,744
Total comprehensive loss							(36,782)
Dividends declared	—	—	—	(33,107)	—	—	(33,107)
Stock compensation costs	—	—	—	2,800	—	—	2,800
Cashless exercise of 128 option shares and related taxes	—	—	—	(757)	—	—	(757)
Issuance of 1,088 shares of common stock, pursuant to stock plans, \$.01 par	10	—	—	6,107	—	—	6,117
Issuance of 9,897 shares of common stock, net of offering costs, \$.01 par	100	—	—	76,207	—	—	76,307
Balance, December 31, 2005	462	—	(18,443)	333,522	(334,727)	322	(18,864)
Components of comprehensive income:							
Net income	—	—	—	—	19,994	—	19,994
Pension liability adjustment	—	—	—	—	—	234	234
Interest rate swap marked to market	—	—	—	—	—	1,010	1,010

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Total comprehensive income							21,238
Dividends declared	—	—	—	(36,274)	—	—	(36,274)
Stock compensation costs	—	—	—	6,870	—	—	6,870
Cashless exercise of 123 stock plan shares and related taxes	—	—	—	(1,175)	—	—	(1,175)
Issuance of 641 shares of common stock stock, pursuant to stock plans, \$.01 par	6	—	—	3,510	—	—	3,516
Retirement of 4,549 shares of stock held in treasury	<u>(45)</u>	<u>—</u>	<u>18,443</u>	<u>(18,398)</u>	<u>—</u>	<u>—</u>	<u>—</u>
Balance, December 31, 2006	<u>\$ 423</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 288,055</u>	<u>\$ (314,733)</u>	<u>\$ 1,566</u>	<u>\$ (24,689)</u>

See Notes to Consolidated Financial Statements

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Consolidated Statements of Cash Flows
Years Ended December 31, 2006, 2005 and 2004
(In Thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Cash Flows from Operating Activities:			
Net income (loss)	\$ 19,994	\$ (41,635)	\$ (39,294)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	63,259	82,819	78,387
Loss (gain) on disposal of assets	1,105	(152)	2,854
Gain on sale of long-term investments	(6,685)	—	—
Amortization of debt issuance costs and original issue discount	5,180	18,760	6,088
Stock compensation costs	6,870	2,800	—
Other non-cash expenses	234	109	12
Changes in components of assets and liabilities:			
Accounts receivable and other current assets	1,118	(2,650)	7,907
Accounts payable and other current liabilities	8,556	(7,977)	22
Deferred charges and other assets	3,882	3,760	1
Other deferred credits	(12,774)	502	3,048
Net cash provided by operating activities	<u>90,739</u>	<u>56,336</u>	<u>59,025</u>
Cash Flows from Investing Activities:			
Construction and capital expenditures	(60,216)	(58,422)	(51,422)
Purchase of short-term investments	(57,500)	(95,095)	(154,650)
Sale of short-term investments	68,025	119,770	162,672
Liquidation of long-term investments	7,663	—	—
Placement of funds in restricted account	—	(700)	(1,055)
Release of funds from escrow	2,715	975	—
Net cash used by investing activities	<u>(39,313)</u>	<u>(33,472)</u>	<u>(44,455)</u>
Cash Flows from Financing Activities:			
Repayments of long-term debt	(61,860)	(459,015)	(26,962)
Proceeds from the issuance of long-term debt	52,900	375,000	—
Debt issuance costs	(1,349)	(11,307)	—
Payment of cash dividend on common stock	(35,475)	(30,393)	—
Issuance of common stock, net	2,341	88,885	9,801
Stock issuance costs	—	(7,817)	—
Purchase of treasury stock	—	—	(1,325)
Net cash used by financing activities	<u>(43,443)</u>	<u>(44,647)</u>	<u>(18,486)</u>
Increase (decrease) in cash	7,983	(21,783)	(3,916)
Cash and cash equivalents at the beginning of the period	<u>28,877</u>	<u>50,660</u>	<u>54,576</u>
Cash and cash equivalents at the end of the period	<u>\$ 36,860</u>	<u>\$ 28,877</u>	<u>\$ 50,660</u>
Supplemental Cash Flow Data:			
Interest paid, net of capitalized interest	\$ 31,280	\$ 39,474	\$ 45,470
Income taxes paid, net of refund	264	—	876
(Increase) decrease in accounts payable for construction and capital expenditures	915	(5,975)	—
Supplemental Noncash Transactions:			
Property acquired under capital leases and mortgages	\$ 60	\$ —	\$ —
Dividend declared, but not paid	9,105	8,347	5,694

See Notes to Consolidated Financial Statements

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Notes to Consolidated Financial Statements, Continued
Years Ended December 31, 2006, 2005, and 2004
(In Thousands, Except Per Share Amounts)

1. DESCRIPTION OF COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Alaska Communications Systems Group, Inc. and Subsidiaries (the "Company" or "ACS Group"), a Delaware corporation, is engaged principally in providing local telephone, wireless, Internet, interexchange network and other services to its retail consumer and business customers and wholesale customers in the State of Alaska through its telecommunications subsidiaries. The Company was formed in October of 1998 for the purpose of acquiring and operating telecommunications properties.

The accompanying consolidated financial statements for the Company are as of December 31, 2006 and 2005 and for the years ended December 31, 2006, 2005 and 2004. They represent the consolidated financial position, results of operations and cash flows principally of ACS Group and the following wholly owned subsidiaries:

- Alaska Communications Systems Holdings, Inc. ("ACS Holdings")
- ACS of Alaska, Inc. ("ACSAK")
- ACS of the Northland, Inc. ("ACSN")
- ACS of Fairbanks, Inc. ("ACSF")
- ACS of Anchorage, Inc. ("ACSA")
- ACS Wireless, Inc. ("ACSW")
- ACS Long Distance, Inc. ("ACSLD")
- ACS Internet, Inc. ("ACSI")

A summary of significant accounting policies followed by the Company is set forth below:

Basis of Presentation

The consolidated financial statements include all majority-owned subsidiaries. In accordance with Statement of Financial Accounting Standards ("SFAS") No. 71, *Accounting for the Effects of Certain Types of Regulation*, intercompany revenue between local telephone and all other segments is not eliminated. All other significant intercompany balances have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the significant estimates affecting the financial statements are those related to the realizable value of accounts receivable, materials and supplies, long-lived assets, goodwill and intangible assets, income taxes and network access revenue reserves. Actual results may differ from those estimates.

Cash and Cash Equivalents

For purposes of the consolidated balance sheets and statements of cash flows, the Company generally considers all highly liquid investments with a maturity at acquisition of three months or less to be cash equivalents.

Restricted Cash

The Company has placed restricted cash in certificates of deposits as required under the terms of certain contracts to which it is a party. When the restrictions are lifted, the Company will transfer the funds back into its operating accounts.

Short-term Investments

Short-term investments include investments in auction-rate securities. Short-term investments are considered available for sale and are carried at amortized cost which approximates fair value.

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Notes to Consolidated Financial Statements, Continued
Years Ended December 31, 2006, 2005, and 2004
(In Thousands, Except Per Share Amounts)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)*Materials and Supplies*

Materials and supplies are carried in inventory at the lower of weighted average cost or market.

Property, Plant and Equipment

Telephone plant is stated substantially at original cost of construction. Telephone plant retired in the ordinary course of business, together with the cost of removal, less salvage, is charged to accumulated depreciation with no gain or loss recognized. Renewals and betterments of telephone plant are capitalized while repairs, as well as renewals of minor items, are charged to operating expense as incurred. The Company provides for depreciation of telephone plant on the straight-line method, using rates approved by regulatory authorities. The composite annualized rate of depreciation for all classes of telephone property, plant, and equipment was 4.6%, 5.8% and 6.1% for 2006, 2005 and 2004, respectively.

Non-Telephone plant is stated at purchased cost, and when sold or retired a gain or loss is recognized. Depreciation of such property is provided on the straight-line method over its estimated service life ranging from three to 20 years.

The Company is the lessee of equipment and buildings under capital leases expiring in various years through 2019. The assets and liabilities under capital leases are initially recorded at the lower of the present value of the minimum lease payments or the fair value of the assets at the inception of the lease. The assets are amortized over the lower of their related lease terms or the estimated productive lives. Amortization of assets under capital leases is included in depreciation and amortization expense for 2006, 2005 and 2004.

The Company is also the lessee of various land, building and personal property under operating lease agreements for which expense is recognized on a monthly basis.

Goodwill

Goodwill and indefinite-lived intangible assets are not amortized but are assessed for impairment on at least an annual basis. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values and are periodically reviewed for impairment. See "Note 5, Goodwill and Other Intangible Assets".

Debt Issuance Costs

Underwriting, legal, accounting, printing and other fees and expenses associated with the issuance of the Company's senior credit facility, senior subordinated notes, senior unsecured notes and senior discount debentures are being amortized using the straight-line method which approximates the effective interest method, over the term of the debt. During 2005, the Company extinguished early its 2003 senior credit facility, senior unsecured notes and senior subordinated notes which resulted in a write off to expense of \$14,784 of debt issuance costs. Debt issuance costs amortization included in loss on extinguishment of debt and interest expense for 2006, 2005 and 2004 was \$3,645, \$16,793 and \$3,457, respectively.

Original Issue Discounts

Certain debt instruments of the Company have been issued below their face value, resulting in original issue discounts that are recorded net in long-term debt. These original issue discounts are amortized using the effective interest method. During 2005, the Company extinguished early its 2003 senior credit facility and repurchased a portion of its 2011 notes which resulted in a write off to expense of \$1,557 of original issue discount. In 2006, the Company repurchased additional 2011 notes which resulted in a write off to expense of \$1,479. Original issue discount amortization included in loss on extinguishment of debt and interest expense for 2006, 2005 and 2004 was \$1,535, \$2,000 and \$2,631, respectively.

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Notes to Consolidated Financial Statements, Continued
Years Ended December 31, 2006, 2005, and 2004
(In Thousands, Except Per Share Amounts)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)*Preferred stock*

The Company has 5,000, no par, shares authorized. Zero was issued or outstanding at December 31, 2006 and 2005.

Treasury Stock

The Company, with Board of Directors' authorization, occasionally repurchases shares of its common stock. Since management intends to hold the treasury stock temporarily for later re-issuance, the cost method of accounting for treasury stock is used. The Company has repurchased a total of 4,749 shares and reissued 200 shares since 2002. On December 15, 2006, the Company's Board of Directors approved the retirement of 100% of the Company's treasury stock.

Revenue Recognition

Substantially all recurring service revenues are billed one month in advance and are deferred until earned. Non-recurring and usage sensitive revenues are billed in arrears and are recognized when earned. Certain of the Company's bundled products and services, primarily in wireless, have been determined to be revenue arrangements with multiple deliverables. Total consideration received in these arrangements is allocated and measured using units of accounting within the arrangement based on relative fair values. Wireless offerings include wireless phones and service contracts sold together in its Company-owned stores. The handset and activation fee revenue associated with these direct channel sales is recognized at the time the related wireless phone is sold and is classified as equipment sales. Monthly service revenue is recognized as services are rendered.

Additionally, the Company establishes estimated bad debt reserves against uncollectible revenues incurred during the period. The Company accounts for bad debt expense in accordance with SFAS No. 71 which prescribes that revenue be recognized net of bad debt expense.

Access revenue is recognized when earned. The Company participates in access revenue pools with other telephone companies. Such pools are funded by toll revenue and/or access charges regulated by the Federal Communications Commission ("FCC") within the interstate jurisdiction. Much of the interstate access revenue is initially recorded based on estimates. These estimates are derived from interim financial statements, available separations studies and the most recent information available about achieved rates of return. These estimates are subject to adjustment in future accounting periods as additional operational information becomes available. To the extent that disputes arise over revenue settlements, the Company's policy is to defer revenue collected until settlement methodologies are resolved and finalized. At December 31, 2006 and 2005, the Company had recorded liabilities of \$21,448 and \$19,197, respectively, related to its estimate of refundable access revenue. The increase in the reserve during the year ended December 31, 2006 of \$2,250 was the net impact of increases to the reserve for the deferral of current period billed revenue, or cash receipts that are subject to dispute. This was offset, in part, by reductions to the reserve for refunds or revenue recognized following the settlement of prior period claims.

During 2005 and 2004, one customer accounted for 10% and 12%, respectively, of consolidated revenues and no customer accounted for more than 10% of consolidated revenue in 2006.

Income Taxes

The Company utilizes the asset-liability method of accounting for income taxes. Under the asset-liability method, deferred taxes reflect the temporary differences between the financial and tax bases of assets and liabilities using the enacted tax rates in effect in the years in which the differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance to the extent that management believes it is more likely than not that such deferred tax assets will not be realized.

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Notes to Consolidated Financial Statements, Continued
Years Ended December 31, 2006, 2005, and 2004
(In Thousands, Except Per Share Amounts)

5. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill is tested for impairment at the reporting unit level at least annually utilizing a two-step methodology. The initial step requires the Company to determine the fair value of each reporting unit and compare it to the carrying value, including goodwill, of such unit. If the fair value exceeds the carrying value, no impairment loss would be recognized. However, if the carrying value of the reporting unit exceeds its fair value, the goodwill of the unit may be impaired. The amount, if any, of the impairment is then measured in the second step. The second step of the goodwill impairment test compares the implied fair value of goodwill of the reporting unit with the carrying amount of that goodwill. The implied fair value of a reporting unit's goodwill is the excess of the fair value of a reporting unit over the amounts assigned to assets and liabilities. If the carrying value amount of reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

The Company annually reassesses previously recognized intangible assets and has ceased amortization of indefinite-lived intangible assets. Wireless and PCS licenses have terms of 10 years, but are renewable indefinitely through a routine process involving a nominal fee. The Company has determined that no legal, regulatory, contractual, competitive, economic or other factors currently exist that limit the useful life of its wireless and PCS licenses. Therefore, the Company is not amortizing its wireless and PCS licenses based on the determination that these assets have indefinite lives. The Company evaluates its determination of indefinite useful lives for its wireless and PCS licenses each reporting period. Indefinite lived intangible assets are tested for impairment at least annually by comparing the fair value of the assets to their carrying amount.

The Company performs its annual impairment test as of the beginning of the fourth quarter or more frequently if events or changes in circumstance indicate possible impairment. The Company determines the fair value of each reporting unit for purposes of this test primarily by using a discounted cash flow valuation technique. Significant estimates used in the valuation include estimates of future cash flows, both future short-term and long-term growth rates, and estimated cost of capital for purposes of arriving at a discount factor. The annual impairment test conducted has resulted in no impairment charges being assessed. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their residual values and reviewed for impairment. The following table provides the gross carrying value and accumulated amortization for each major class of intangible asset as of December 31, 2006 based on the Company's reassessment of previously recognized intangible assets and their remaining amortization lives:

	<u>Carrying Amount</u>
Amortizable intangible assets:	
Customer lists	\$ 915
Less: Accumulated amortization	<u>(915)</u>
	<u>—</u>
Indefinite-lived intangible assets:	
Cellular licenses	18,193
PCS licenses	3,323
Domain names and trade names	88
	<u>21,604</u>
 Total intangible assets	 <u>\$ 21,604</u>

For amortizable intangible assets the total intangible amortization expense for the years ended December 31, 2006, 2005 and 2004 was \$91, \$183 and \$183, respectively.

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Notes to Consolidated Financial Statements, Continued
Years Ended December 31, 2006, 2005, and 2004
(In Thousands, Except Per Share Amounts)

8. OTHER DEFERRED CREDITS AND LONG-TERM LIABILITIES

Deferred credits and other long-term liabilities consist of the following at December 31, 2006 and 2005:

	<u>2006</u>	<u>2005</u>
Regulatory liabilities — accumulated removal costs	\$ 61,486	\$ 58,154
Refundable access revenue	7,912	16,256
Other deferred credits	2,591	2,450
Pension obligations	892	5,363
	<u>\$ 72,881</u>	<u>\$ 82,223</u>

9. LOCAL TELEPHONE OPERATING REVENUE

Local telephone operating revenues consist of the following for the years ended December 31:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Local network service	\$ 80,177	\$ 86,482	\$ 91,669
Network access revenue	90,894	92,379	97,536
Deregulated revenue and other	20,987	23,981	21,982
	<u>\$ 192,058</u>	<u>\$ 202,842</u>	<u>\$ 211,187</u>

10. NON-OPERATING CHARGES

The Company periodically evaluates the fair value of its investments and other non-operating assets against their carrying value whenever market conditions indicate a change in that fair value. Any changes relating to declines in the fair value of non-operating assets are charged to non-operating expense under the caption "Other" in the Consolidated Statement of Operations. During 2003, the Company undertook an assessment of the net realizable value of its note receivable from Crest Communications LLC ("Crest") and the option, as part of the note receivable, to purchase certain network assets from Crest as a result of changes in market and economic conditions (and a notice the Company received from the State of Alaska of termination of the TPA). As a result of the analysis, the Company recorded a charge of \$15,924 representing the estimated decline in fair value of the note receivable from Crest. During 2005, the full balance of the note and accrued interest of \$2,692 was fully reserved. In January 2006, the Company executed definitive agreements to assume ownership of strategic fiber optic cable network assets from Crest. As previously disclosed, pursuant to the Company's 2002 agreement with Crest, the Company was granted an option to exchange its \$15,000 note for the strategic assets. See "Note 21 – Other Events" for more information on this transaction.

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Notes to Consolidated Financial Statements, Continued
Years Ended December 31, 2006, 2005, and 2004
(In Thousands, Except Per Share Amounts)

14. RETIREMENT PLANS (Continued)

The ACS Health Plan's asset allocations at December 31, 2006 and 2005, by asset category, are as follows:

Asset Category	2006	2005
Equity securities*	34%	33%
Debt securities*	59%	63%
Other/Cash	7%	4%
Total	<u>100%</u>	<u>100%</u>

* Note that mutual funds that may contain both stock and bonds may be included in these categories.

The fundamental investment objective of the plan is to realize an annual total investment return consistent with the conservative risk tolerance plan dictated by the Company. The investment profile of the plan emphasizes liquidity and income, some capital stock investment and some fluctuation of investment return. It is anticipated that the investment manager will achieve this objective by investing the account's assets in mutual funds. The portfolio may hold common stock, fixed income securities, money market instruments and U.S. Treasury obligations.

Based on risk and return history for capital markets along with asset allocation risk and return projections, the following asset allocation guidelines were developed for the plan:

	<u>Target</u>
Equity securities	30%
Fixed income	60%
Other/cash	10%

The benefits expected to be paid in the each of the next five years, and in the aggregate for the five fiscal years thereafter are as follows:

2007	\$16
2008	16
2009	16
2010	16
2011	16
2012-2016	58

15. BUSINESS SEGMENTS

The Company has four reportable segments: local telephone, wireless, Internet and interexchange. Local telephone provides landline telecommunications services and consists of local telephone service, network access and deregulated and other revenue; wireless provides wireless telecommunications service; Internet provides Internet service and advanced IP based private networks and interexchange provides switched and dedicated long distance services. Each reportable segment is a strategic business and offers different services than those offered by the other segments. The Company evaluates the performance of its segments based on operating income (loss) and other quantitative factors related to the overall contribution of individual products and services to total Company performance.

The Company incurs interest expense, interest income, equity in earnings of investments and other operating and non-operating income and expense at the corporate level which are not allocated to the business segments, or evaluated by the chief operating decision maker in analyzing the performance of the business segments. These non-operating income and expense items are provided in the accompanying table under the caption "All Other" in order to assist the users of these financial statements in reconciling the operating results and total assets of the business segments to the consolidated financial statements. Common use assets are held at either the Company or ACS Holdings and are allocated to the business segments based on operating revenue. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

Table of Contents

ALASKA COMMUNICATIONS SYSTEMS GROUP, INC.
Notes to Consolidated Financial Statements, Continued
Years Ended December 31, 2006, 2005, and 2004
(In Thousands, Except Per Share Amounts)

15. BUSINESS SEGMENTS (Continued)

The following table illustrates selected financial data for each segment as of and for the year ended December 31, 2006:

	Local Telephone	Wireless	Internet	Interexchange	All Other	Eliminations	Total
Operating revenues	\$192,062	\$115,627	\$25,473	\$25,317	\$ 10,702	\$(19,364)	\$349,817
Depreciation and amortization	43,464	11,503	3,669	223	4,400	—	63,259
Operating income (loss)	9,810	38,034	(8,851)	7,010	4,992	—	50,995
Interest expense	(419)	(4)	—	(177)	(30,503)	—	(31,103)
Loss on extinguishment of debt	—	—	—	—	(9,650)	—	(9,650)
Interest income	1	—	—	—	1,834	—	1,835
Income tax (expense) benefit	(3,821)	(15,578)	—	—	18,956	—	(443)
Net income (loss)	5,571	22,451	(8,851)	6,833	(6,010)	—	19,994
Total assets	402,331	146,650	37,614	25,563	5,124	(54,961)	562,321
Capital expenditures	29,958	14,341	6,598	2,315	6,149	—	59,361

Operating revenue disclosed above includes inter-segment operating revenue of \$52,178 of which \$19,364 is eliminated. By segment, intercompany revenue balances are as follows: local telephone, \$29,265 of which \$19 is eliminated; wireless, \$2,632 of which \$43 is eliminated; Internet, \$465 of which \$252 is eliminated; interexchange, \$9,129 of which \$8,363 is eliminated; and all other, \$10,687 of which \$10,687 is eliminated. In accordance with SFAS No. 71, intercompany revenue between local telephone and all other segments is not eliminated above. Also eliminated above, is \$54,961 of Internet intercompany payable balances which are recorded in the consolidated statements net of affiliate receivables.

The following table illustrates selected financial data for each segment as of and for the year ended December 31, 2005:

	Local Telephone	Wireless	Internet	Interexchange	All Other	Eliminations	Total
Operating revenues	\$202,845	\$ 86,279	\$21,924	\$21,434	\$ 22,624	\$(28,297)	\$326,809
Depreciation and amortization	52,655	10,521	3,950	301	15,392	—	82,819
Operating income (loss)	3,209	23,577	(6,427)	284	6,498	—	27,141
Interest expense	(454)	(2)	—	(182)	(35,256)	—	(35,894)
Loss on extinguishment of debt	—	—	—	—	(34,882)	—	(34,882)
Interest income	—	—	—	—	2,253	—	2,253
Income tax (expense) benefit	(1,267)	(9,694)	—	—	10,961	—	—
Net income (loss)	1,488	13,861	(6,427)	102	(50,659)	—	(41,635)
Total assets	423,815	127,777	35,226	21,847	11,668	(43,920)	576,413
Capital expenditures	30,173	12,148	15,296	455	6,325	—	64,397

Operating revenue disclosed above includes inter-segment operating revenue of \$60,516 of which \$28,297 is eliminated. By segment, intercompany revenue balances are as follows: local telephone, \$28,782 of which \$17 is eliminated; wireless, \$2,524 of which \$44 is eliminated; Internet, \$453 of which \$252 is eliminated; interexchange, \$6,147 of which \$5,374 is eliminated; and all other, \$22,610 of which \$22,610 is eliminated. In accordance with SFAS No. 71, intercompany revenue between local telephone and all other segments is not eliminated above. Also eliminated above, is \$1,644 and \$42,276 of wireless and Internet intercompany payable balances which are recorded in the consolidated statements net of affiliate receivables.



Form 10-K

CENTURYTEL INC - CTL

Filed: March 01, 2007 (period: December 31, 2006)

Annual report which provides a comprehensive overview of the company for the past year

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

RESULTS OF OPERATIONS

OVERVIEW

CenturyTel, Inc., together with its subsidiaries, is an integrated communications company engaged primarily in providing an array of communications services, including local and long distance voice, Internet access and broadband services, to customers in 25 states. We currently derive our revenues from providing (i) local exchange and long distance voice services, (ii) network access services, (iii) data services, which includes both high-speed ("DSL") and dial-up Internet services, as well as special access and private line services, (iv) fiber transport, competitive local exchange and security monitoring services and (v) other related services.

Our results of operations in 2006 were adversely impacted as a result of (i) lower Universal Service Fund and intrastate access revenues, (ii) declines in access lines, (iii) the recognition of stock option expense in accordance with SFAS 123(R) and (iv) expenses associated with expanding our new video and wireless service offerings. See below for additional information.

On June 30, 2005, we acquired fiber assets in 16 metropolitan markets from KMC Telecom Holdings, Inc. ("KMC") for approximately \$75.5 million cash.

On March 1 and August 31, 2006, we announced workforce reductions involving an aggregate of approximately 400 jobs and, in connection therewith, incurred a net pre-tax charge of approximately \$7.5 million (consisting of a \$9.4 million charge to operating expenses, net of a \$1.9 million favorable revenue impact related to such expenses) for severance and related costs. See Note 8 for additional information.

In the second quarter of 2006, we (i) recorded a one-time pre-tax gain of approximately \$117.8 million upon redemption of our investment in the stock of the Rural Telephone Bank ("RTB") and (ii) sold our local exchange operations in Arizona. See Note 15 for additional information.

Our net income for 2006 was \$370.0 million, compared to \$334.5 million during 2005 and \$337.2 million during 2004. Diluted earnings per share for 2006 was \$3.07 compared to \$2.49 in 2005 and \$2.41 in 2004. The increase in diluted earnings per share is primarily attributable to lower average shares outstanding in 2006 compared to prior years due to share repurchases that have occurred during the past two years and to the gain recorded upon redemption of our investment in RTB stock.

OCA Exh. King 65 P

Year ended December 31,	2006	2005	2004
	(Dollars, except per share amounts, and shares in thousands)		
Operating income	\$ 665,538	736,403	753,953
Interest expense	(195,957)	(201,801)	(211,051)
Other income (expense)	121,568	3,168	4,470
Income tax expense	(221,122)	(203,291)	(210,128)
Net income	\$ 370,027	334,479	337,244
Basic earnings per share	\$ 3.17	2.55	2.45
Diluted earnings per share	\$ 3.07	2.49	2.41
Average basic shares outstanding	116,671	130,841	137,215
Average diluted shares outstanding	122,229	136,087	142,144

Operating income decreased \$70.9 million in 2006 due to a \$31.5 million decrease in operating revenues and a \$39.3 million increase in operating expenses. Operating income decreased \$17.6 million in 2005 as a \$71.9 million increase in operating revenues was more than offset by an \$89.4 million increase in operating expenses.

In addition to historical information, this management's discussion and analysis includes certain forward-looking statements that are based on current expectations only, and are subject to a number of risks, uncertainties and assumptions, many of which are beyond our control. Actual events and results may differ materially from those anticipated, estimated or projected if one or more of these risks or uncertainties materialize, or if underlying assumptions prove incorrect. Factors that could affect actual results include but are not limited to: the timing, success and overall effects of competition from a wide variety of competitive providers; the risks inherent in rapid technological change; the effects of ongoing changes in the regulation of the communications industry; our ability to effectively manage our expansion opportunities, including successfully financing, consummating and integrating pending acquisitions and retaining and hiring key personnel; possible changes in the demand for, or pricing of, our products and services; our ability to successfully introduce new product or service offerings on a timely and cost-effective basis; our ability to collect our receivables from financially troubled communications companies; our ability to successfully negotiate collective bargaining agreements on reasonable terms without work stoppages; the effects of adverse weather; other risks referenced from time to time in this report or other of our filings with the Securities and Exchange Commission; and the effects of more general factors such as changes in interest rates, in tax rates, in accounting policies or practices, in operating, medical or administrative costs, in general market, labor or economic conditions, or in legislation, regulation or public policy. These and other uncertainties related to our business are described in greater detail in Item 1A included herein. You should be aware that new factors may emerge from time to time and it is not possible for us to identify all such factors nor can we predict the impact of each such factor on the business or the extent to which any one or more factors may cause actual results to differ from those reflected in any forward-looking statements. You are further cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. We undertake no obligation to update any of our forward-looking statements for any reason.

All references to "Notes" in this Item 7 refer to the Notes to Consolidated Financial Statements included in Item 8 of this annual report.

OPERATING REVENUES

Year ended December 31,	2006	2005	2004
	(Dollars in thousands)		
Voice	\$ 860,741	892,272	903,025
Network access	878,702	959,838	966,011
Data	351,495	318,770	275,777
Fiber transport and CLEC	149,088	115,454	74,409
Other	207,704	192,918	188,150
Operating revenues	\$ 2,447,730	2,479,252	2,407,372

As a result of increased bundling of our local exchange and long distance service offerings, beginning in 2006, we have combined the revenues of such offerings into a category entitled "Voice". We have restated prior periods to insure comparability.

Voice revenues. We derive voice revenues by providing local exchange telephone services and retail long distance services to customers in our service areas. The \$31.5 million (3.5%) decrease in voice revenues in 2006 is primarily due to (i) a \$22.3 million decrease due a 4.8% decline in the number of access lines served and (ii) a \$26.1 million decline as a result of a decrease in minutes of use in extended area calling plans in certain areas. Such decreases were partially offset by (i) a \$12.6 million increase in long distance revenues primarily attributable to an increase in the number of long distance lines and increased long distance minutes of use, both of which were partially offset by a decline in the average rate we charged our long distance customers and (ii) a \$9.9 million increase due to providing custom calling features to more customers. The \$10.8 million (1.2%) decrease in voice revenues in 2005 is primarily due to (i) a \$16.5 million decrease due to a decrease in the average rate we charged our long distance customers, (ii) a \$16.1 million decrease due a 3.3% decline in the average number of access lines served, and (iii) a \$7.5 million decline as a result of a decrease in minutes of use in extended area calling plans in certain areas. Such decreases were partially offset by (i) a \$21.2 million increase in long distance revenues attributable to a 12.0% increase in the average number of long distance lines served and a 12.8% increase in minutes of use and (ii) an \$8.7 million increase due to providing custom calling features to more customers.

Excluding (i) the sale of our Arizona telephone operations in May 2006 and (ii) the net impact of removing test lines from our access line counts and adding lines as a result of converting and correcting our databases during 2006, access lines declined 107,000 (4.8%) during 2006 compared to a decline of 99,500 (4.3%) in 2005. We believe the decline in the number of access lines during the past few years is primarily due to the displacement of traditional wireline telephone services by other competitive services. We expect access lines to decline between 4.5% and 6.0% during 2007.

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Network access revenues. We derive our network access revenues primarily from (i) providing services to various carriers and customers in connection with the use of our facilities to originate and terminate their interstate and intrastate voice and data transmissions and (ii) receiving universal support funds which allows us to recover a portion of our costs under federal and state cost recovery mechanisms. Certain of our interstate network access revenues are based on tariffed access charges filed directly with the Federal Communications Commission ("FCC"); the remainder of such revenues (except for DSL-related revenues) are derived under revenue sharing arrangements with other local exchange carriers ("LECs") administered by the National Exchange Carrier Association. Intrastate network access revenues are based on tariffed access charges filed with state regulatory agencies or are derived under revenue sharing arrangements with other LECs.

Network access revenues decreased \$81.1 million (8.5%) in 2006 and decreased \$6.2 million (0.6%) in 2005 due to the following factors:

	2006 increase (decrease)	2005 increase (decrease)
(Dollars in thousands)		
Recovery from the federal Universal Service High Cost Loop support program	\$ (11,637)	(13,065)
Intrastate revenues due to decreased minutes of use, decreased access rates in certain states and recovery from state support funds	(16,326)	(13,392)
Partial recovery of operating costs through revenue sharing arrangements with other telephone companies, interstate access revenues and return on rate base	(16,825)	6,819
Rate changes in certain jurisdictions	(2,875)	(3,457)
Prior year revenue settlement agreements	(31,219)	15,947
Other, net	(2,254)	975
	\$ (81,136)	(6,173)

Our revenues from the Universal Service High Cost Loop Fund decreased approximately \$11.6 million in 2006 and \$13.1 million in 2005, primarily due to an increase in the nationwide average cost per loop factor used by the FCC to allocate funds among all recipients. We anticipate our 2007 revenues from the federal Universal Service High Cost Loop support program will be approximately the same as 2006 levels.

In 2006, we experienced a reduction in our intrastate revenues of approximately \$16.3 million primarily due to a reduction in intrastate minutes (partially due to the displacement of minutes by wireless, electronic mail and other optional calling services). The corresponding decrease in 2005 compared to 2004 was \$13.4 million. We believe intrastate minutes will continue to decline in 2007, although the magnitude of such decrease is uncertain.

Prior year revenue settlement agreements for 2005 included the recognition of approximately \$35.9 million of revenue settlements for prior periods that did not recur in 2006. Of the \$35.9 million recognized, \$24.5 million was reflected in network access revenues and \$11.4 million was reflected in data revenues.

Data revenues. We derive our data revenues primarily by providing Internet access services (both DSL and dial-up services) and data transmission services over special circuits and private lines. Data revenues increased \$32.7 million (10.3%) in 2006 and \$43.0 million (15.6%) in 2005. The 2006 increase was substantially due to a \$54.0 million increase in DSL-related revenues primarily due to growth in the number of high-speed Internet customers. Such increase was partially offset by a decrease in prior year revenue settlements due to the above-described recognition of approximately \$11.4 million of revenue in the third quarter of 2005 and a \$4.9 million decrease due to a reduced number of dial-up Internet customers.

The \$43.0 million increase in 2005 was primarily due to (i) a \$24.8 million increase in Internet revenues due primarily to growth in the number of high-speed Internet customers, partially offset by a decrease in the number of dial-up customers, (ii) a \$10.8 million increase in special access revenues due to an increase in the number of special circuits provided and an increase in the partial recovery of our increased operating expenses through revenue sharing arrangements with other telephone companies, and (iii) an \$8.6 million net increase in revenues related to prior year settlement agreements driven principally by the above-described non-recurring increase in the third quarter of 2005.

Fiber transport and CLEC. Our fiber transport and CLEC revenues include revenues from our fiber transport, competitive local exchange carrier ("CLEC") and security monitoring businesses. Fiber transport and CLEC revenues increased \$33.6 million (29.1%) in 2006, of which \$24.4 million was due to revenues from the fiber assets acquired on June 30, 2005 from KMC and \$8.5 million was attributable to growth in our incumbent fiber transport business. Fiber transport and CLEC revenues increased \$41.0 million (55.2%) in 2005, of which \$27.7 million was due to revenue from the June 30, 2005 acquisition of fiber assets from KMC and \$12.4 million was attributable to growth in our incumbent fiber transport business.

Other revenues. We derive other revenues primarily by (i) leasing, selling, installing and maintaining customer premise telecommunications equipment and wiring, (ii) providing billing and collection services for third parties, (iii) participating in the publication of local directories and (iv) providing new service offerings, principally consisting of our new video and wireless reseller services. Other revenues increased \$14.8 million (7.7%) during 2006 primarily due to a \$12.1 million increase in revenues of our video and wireless reseller offerings and \$2.5 million increase in directory revenues. Other revenues increased \$4.8 million (2.5%) during 2005 primarily due to a \$4.5 million increase in directory revenues.

OPERATING EXPENSES

Year ended December 31,	2006	2005	2004
	(Dollars in thousands)		
Cost of services and products (exclusive of depreciation and amortization)	\$ 888,414	821,929	755,413
Selling, general and administrative	370,272	388,989	397,102
Depreciation and amortization	523,506	531,931	500,904
Operating expenses	\$ 1,782,192	1,742,849	1,653,419

Cost of services and products. Cost of services and products increased \$66.5 million (8.1%) in 2006 primarily due to (i) an \$18.9 million increase in expenses incurred by the properties acquired from KMC; (ii) an \$18.3 million increase in costs associated with growth in our long distance business; (iii) a \$14.3 million increase in expenses associated with our video and wireless reseller service offerings; (iv) an \$11.5 million increase in Internet operating expenses primarily due to growth in the number of high-speed Internet customers; and (v) \$8.6 million of severance and related costs associated with our workforce reduction (see Note 8).

Cost of services and products increased \$66.5 million (8.8%) in 2005 primarily due to (i) a \$21.9 million increase in expenses incurred by the properties acquired from KMC in June 2005; (ii) a \$16.4 million increase in expenses associated with our Internet operations primarily due to an increase in the number of high-speed Internet customers; (iii) a \$10.6 million increase in costs associated with growth in our fiber transport business; (iv) a \$9.0 million increase in salaries and benefits; (v) an \$8.2 million increase in access expenses; (vi) a \$5.3 million increase due to start-up costs associated with our new video and wireless reseller services; and (vii) a \$4.3 million increase in costs associated with growth in our long distance business. Such increases were partially offset by (i) a \$3.9 million decrease in expenses caused by us settling certain pole attachment disputes in 2005 for amounts less than those previously accrued and (ii) a \$3.4 million decrease in customer service expense.

Selling, general and administrative. Selling, general and administrative expenses decreased \$18.7 million (4.8%) in 2006 primarily due to an \$11.0 million decrease in marketing expenses; a \$10.6 million reduction in information technology expenses; an \$8.7 million reduction in bad debt expense; and a \$5.8 million decrease in operating taxes. These decreases were partially offset by a \$9.9 million increase in salaries and benefits and a \$5.5 million increase in expenses incurred from the properties acquired from KMC.

Selling, general and administrative expenses decreased \$8.1 million (2.0%) in 2005 primarily due to (i) a \$12.4 million decrease in operating taxes (primarily due to an \$8.6 million one-time charge in the third quarter of 2004); (ii) an \$11.2 million reduction in bad debt expense, and (iii) a \$4.6 million decrease in expenses attributable to our Sarbanes-Oxley internal controls compliance effort. Such decreases were partially offset by (i) \$7.9 million of expenses incurred by the properties acquired from KMC; (ii) a \$5.9 million increase in customer service and marketing costs associated with growth in our Internet business and (iii) a \$2.8 million increase in sales and marketing costs associated with our new video and wireless reseller services.

Depreciation and amortization. Depreciation and amortization decreased \$8.4 million (1.6%) in 2006, primarily due to a \$25.3 million reduction in depreciation expense due to certain assets becoming fully depreciated. Such decreases were partially offset by (i) a \$16.6 million increase due to higher levels of plant in service and (ii) a \$3.1 million increase due to depreciation and amortization of the properties acquired from KMC.

Depreciation and amortization increased \$31.0 million (6.2%) in 2005. The year 2004 included a one-time reduction in depreciation expense of \$13.2 million to adjust the balances of certain over-depreciated property, plant and equipment accounts. The remaining \$17.8 million increase in 2005 is primarily due to (i) a \$19.0 million increase due to higher levels of plant in service, (ii) a \$6.1 million increase associated with amortization of our new billing system and (iii) a \$2.8 million increase due to depreciation and amortization incurred by the properties acquired from KMC. Such increases were partially offset by (i) a \$7.8 million reduction in depreciation expense due to certain assets becoming fully depreciated and (ii) the non-recurrence in 2005 of a \$3.1 million one-time increase recorded in 2004 related to the depreciation of fixed assets associated with our new billing system.

Other. For additional information regarding certain matters that have impacted or may impact our operations, see "Regulation and Competition".

INTEREST EXPENSE

Interest expense decreased \$5.8 million (2.9%) in 2006 compared to 2005 as a \$10.5 million decrease due primarily to a decrease in average debt outstanding was partially offset by a \$7.1 million increase due to higher average interest rates.

Interest expense decreased \$9.3 million (4.4%) in 2005 compared to 2004 as a \$16.1 million decrease due primarily to a decrease in average debt outstanding was partially offset by a \$7.7 million increase due to higher average interest rates.

OTHER INCOME (EXPENSE)

Other income (expense) includes the effects of certain items not directly related to our core operations, including gains/losses from asset dispositions and impairments, our share of income from our 49% interest in a cellular partnership, interest income and allowance for funds used during construction. Other income (expense) was \$121.6 million in 2006, \$3.2 million in 2005 and \$4.5 million in 2004. The years 2006, 2005 and 2004 were impacted by certain charges and credits that are not expected to occur in the future. Included in 2006 were pre-tax gains of approximately \$118.6 million, substantially all of which related to the redemption of our RTB stock upon dissolution of the RTB, which were partially offset by pre-tax charges of approximately \$11.7 million due to the impairment of certain non-operating investments. Included in 2005 was (i) a \$16.2 million pre-tax charge due to the impairment of a non-operating investment; (ii) a \$4.8 million debt extinguishment expense related to purchasing and retiring approximately \$400 million of our Senior J notes; (iii) \$3.2 million of non-recurring interest income related to the settlement of various income tax audits; and (iv) a \$3.5 million gain from the sale of a non-operating investment. Included in 2004 was a \$3.6 million prepayment expense paid in connection with the redemption of \$100 million aggregate principal amount of our Series B senior notes in May 2004 and a \$2.5 million charge related to the impairment of a non-operating investment.

S COMMUNICATIONS COMPANY

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE YEAR ENDED DECEMBER 31, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

(Mark one)

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

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 001-11001

CITIZENS COMMUNICATIONS COMPANY
(Exact name of registrant as specified in its charter)

Delaware

06-0619596

(State or other jurisdiction of
No.)
incorporation or organization)

(I.R.S. Employer Identification

3 High Ridge Park
Stamford, Connecticut

06905

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (203) 614-5600

CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES

PART I

Item 1. Business

Citizens Communications Company (Citizens) and its subsidiaries will be referred to as the "Company," "we," "us" or "our" throughout this report. Citizens was incorporated in the State of Delaware in 1935 as Citizens Utilities Company.

We are a communications company providing services to rural areas and small and medium-sized towns and cities. We offer our services under the "Frontier" name. Revenue from our Frontier operations was \$2.025 billion in 2006. Among the highlights for 2006:

* Proposed Acquisition On September 17, 2006, we entered into a definitive agreement to acquire Commonwealth Telephone Enterprises, Inc. (Commonwealth). Total consideration (cash and stock) to be paid is approximately \$1.2 billion. We expect to close this transaction in the first half of 2007.

* Cash Generation We continued to grow free cash flow through further growth of broadband and value added services, productivity improvements, and a disciplined capital expenditure program that emphasizes return on investment. In 2006, we sold our competitive local exchange carrier (CLEC), Electric Lightwave, LLC, or ELI (including the sale of associated real estate), for approximately \$255 million in cash. We also received approximately \$65 million from the dissolution of the Rural Telephone Bank.

* Stockholder Value During 2006, we repurchased \$135.2 million of our common stock and we continued to pay an annual dividend of \$1.00 per common share.

* Growth During 2006, we added approximately 75,100 new high-speed internet customers and almost 88,200 customers began buying a bundle or package of our services. At December 31, 2006, we had approximately 393,200 high-speed data customers and almost 517,700 customers buying a bundle or package of services. During 2005, we also began offering a television product in partnership with Echostar's DISH Network, and at the end of 2006 we had approximately 62,900 customers.

Our objective is to be the leading provider of communications services to homes and businesses in our service areas. We are committed to delivering innovative and reliable products and solutions with an emphasis on convenience, service and customer satisfaction. We offer a variety of voice, television and internet services that are available as bundled or package solutions or, for some products, a la carte. We believe that superior customer service and innovative product positioning will continue to differentiate us from our competitors in the marketplace.

Telecommunications Services

As of December 31, 2006, we operated as an incumbent local exchange carrier in 23 states.

Frontier is typically the dominant incumbent carrier in the markets we serve and provides the "last mile" of telecommunications services to residential and business customers in these markets.

The telecommunications industry is undergoing significant changes and difficulties and our financial results reflect the impact of this challenging environment. As discussed in more detail in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), we operate in an increasingly challenging environment and, accordingly, our Frontier revenues have been growing only slightly.

Our business, under the Frontier name, is primarily with residential customers and, to a lesser extent, non-residential customers. Our Frontier services include:

* access services,

- * local services,
- * long distance services,
- * data and internet,
- * directory services, and
- * television services.

Access services. Switched access services allow other carriers the use of our facilities to originate and terminate their long distance voice and data traffic. These services are generally offered on a month-to-month basis and the service is billed on a minutes-of-use basis. Access charges are based on access rates filed with the Federal Communications Commission (FCC) for interstate services and with the respective state regulatory agency for intrastate services. In addition, subsidies received from state and federal universal service funds based on the high cost of providing telephone service to certain rural areas are a part of our access services revenue.

Revenue is recognized when services are provided to customers or when products are delivered to customers. Monthly recurring network access service revenue is billed in advance. The unearned portion of this revenue is initially deferred on our balance sheet and recognized in revenue over the period that the services are provided.

Local services. We provide basic telephone wireline services to residential and non-residential customers in our service areas. Our service areas are largely residential and are generally less densely populated than the primary service areas of the largest incumbent local exchange carriers. We also provide enhanced services to our customers by offering a number of calling features including call forwarding, conference calling, caller identification, voicemail and call waiting. All of these local services are billed monthly in advance. The unearned portion of this revenue is initially deferred on our balance sheet and recognized in revenue over the period that the services are provided. We also offer packages of communications services. These packages permit customers to bundle their basic telephone line with their choice of enhanced, long distance, television and internet services for a monthly fee and/or usage fee depending on the plan.

We intend to continue to increase the penetration of enhanced services. We believe that increased sales of such services will produce revenue with higher operating margins due to the relatively low marginal operating costs necessary to offer such services. We believe that our ability to integrate these services with other services will provide us with the opportunity to capture an increased percentage of our customers' communications expenditures.

Long distance services. We offer long distance services in our territories to our customers. We believe that many customers prefer the convenience of obtaining their long distance service through their local telephone company and receiving a single bill. Long distance network service to and from points outside of our operating territories is provided by interconnection with the

facilities of interexchange carriers, or IXC's. Our long distance services are billed either as unlimited/fixed number of minutes in advance or on a per minute of use basis, in which case it is billed in arrears.

Data and internet services. We offer data services including internet access (via dial up or high-speed internet access), frame relay, ethernet and asynchronous transfer mode (ATM) switching services. We offer other data transmission services to other carriers and high-volume commercial customers with dedicated high-capacity circuits like DS-1's and DS-3's. Such services are generally offered on a contract basis and the service is billed on a fixed monthly recurring charge basis. Data and internet services are typically billed monthly in advance.

Directory services. Directory services involves the provision of white and yellow page directories of residential and business listings. We provide this service through a third-party contractor and are paid a percentage of revenues from the sale of advertising in these directories. Our directory service also includes "Frontier Pages," an internet-based directory service which generates advertising revenue. We recognize the revenue from these services over the life of the related white or yellow pages book.

Television services. We offer a television product in partnership with Echostar's DISH Network (DISH). We provide access to all-digital television channels featuring movies, sports, news, music, and high-definition TV programming. We offer packages that include 100, 200 or 250 channels, high-definition channels, family channels and ethnic channels. We are in an "agency" relationship with DISH. We bill the customer for the monthly services and remit those billings to DISH without recognizing any revenue. We in-turn receive from DISH and recognize as revenue activation fees and a nominal billing and collection fee.

Wireless services. During 2006, we began offering wireless data services in certain markets. Our wireless data services utilize technologies that are relatively new, and we depend to some degree on the representations of equipment vendors, lab testing and the experiences of others who have been successful at deploying these new technologies. During 2007, we expect to begin offering differentiated wireless voice and data packages in certain markets. Our success in offering wireless voice services will, to a great extent, be determined by the relationships we are developing with both wireless carriers and switching equipment vendors, and is also dependent on their capabilities.

In the fourth quarter of 2006, the Company revised its reporting of certain operating metrics to be consistent with those used by management to run the business. The data reported below is consistent with that used by management internally on a daily basis.

The following table sets forth certain information with respect to our revenue generating units (RGUs), which consists of access lines plus high-speed internet subscribers, as of December 31, 2006 and 2005.

State	Frontier RGUs at December 31,	
	2006	2005
New York.....	952,500	1,001,500
Minnesota.....	296,900	296,400
Arizona.....	198,700	196,000
California.....	190,200	188,400
West Virginia.....	178,100	171,000
Illinois.....	129,100	130,800
Tennessee.....	111,000	110,300
Wisconsin.....	77,600	77,100
Iowa.....	57,600	59,200
Nebraska.....	54,100	55,700
All other states (13)...	274,000	269,200
Total	2,519,800	2,555,600

Change in the number of our access lines is important to our revenue and profitability. We have lost access lines primarily because of competition, changing consumer behavior, economic conditions, changing technology and because some customers disconnect second lines when they add high-speed internet or cable modem service. We lost approximately 111,000 access lines during the year ended December 31, 2006, but added over 75,100 high-speed internet subscribers during this same period. We lost 98,800 residential customer lines and 12,200 non-residential customer lines in 2006. The non-residential line losses were principally in Rochester, New York, while the residential losses were throughout our markets. We expect to continue to lose access lines but to increase high-speed internet subscribers during 2007. A continued loss of access

lines, combined with increased competition and the other factors discussed in MD&A, may cause our profitability and cash flows to decrease during 2007.

Regulatory Environment

General

The majority of our operations are regulated by various state regulatory agencies, often called public service or utility commissions, and the FCC.

Our revenue is subject to regulation by the FCC and various state regulatory agencies. We expect federal and state lawmakers to continue to review the statutes governing the level and type of regulation for telecommunications services.

The Telecommunications Act of 1996, or the 1996 Act, dramatically changed the telecommunications industry. The main purpose of the 1996 Act was to open local telecommunications marketplaces to competition. The 1996 Act preempts state and local laws to the extent that they prevent competition with respect to communications services. Under the 1996 Act, however, states retain authority to impose requirements on carriers necessary to preserve universal service, protect public safety and welfare, ensure quality of service and protect consumers. States are also responsible for mediating and arbitrating interconnection agreements between CLECs and ILECs if voluntary negotiations fail. In order to create an environment in which local competition is a practical possibility, the 1996 Act imposes a number of requirements for access to network facilities and interconnection on all local communications providers. All incumbent local carriers must interconnect with other carriers, unbundle some of their services at wholesale rates, permit resale of some of their services, enable collocation of equipment, provide local telephone number portability and dialing parity, provide access to poles, ducts, conduits and rights-of-way, and complete calls originated by competing carriers under termination arrangements.

At the federal level and in a number of the states in which we operate, we are subject to price cap or incentive regulation plans under which prices for regulated services are capped in return for the elimination or relaxation of earnings oversight. The goal of these plans is to provide incentives to improve efficiencies and increased pricing flexibility for competitive services while ensuring that customers receive reasonable rates for basic services. Some of these plans have limited terms and, as they expire, we may need to renegotiate with various states. These negotiations could impact rates, service quality and/or infrastructure requirements which could impact our earnings and capital expenditures. In other states in which we operate, we are subject to rate of return regulation that limits levels of earnings and returns on investments. In some states, we have been required to refund customers as a result of exceeding earnings limitations. In a small number of states (California, Alabama, Iowa, Indiana, Michigan, Nebraska), we have been successful in reducing or eliminating price regulation on services under state commission jurisdiction. We continue to advocate our position of less regulation with various regulatory agencies.

For interstate services regulated by the FCC, we have elected a form of incentive regulation known as "price caps" for most of our operations. In May 2000, the FCC adopted a methodology for regulating the interstate access rates of price cap companies through May 2005. The program, known as the Coalition for Affordable Local and Long Distance Services, or CALLS plan, reduced prices for interstate-switched access services and phased out many of the implicit subsidies in interstate access rates. The CALLS program expired in 2005. The FCC may address future changes in interstate access charges during 2007 and such changes may adversely affect our revenues and profitability.

Another goal of the 1996 Act was to remove implicit subsidies from the rates charged by local telecommunications companies. The CALLS plan addressed this requirement for interstate services. State legislatures and regulatory agencies are beginning to reduce the implicit subsidies in intrastate rates. The most common subsidies are in access rates that historically have been priced above their costs to allow basic local rates to be priced below cost. Legislation has been

considered in several states to require regulators to eliminate these subsidies and implement state universal service programs where necessary to maintain reasonable basic local rates. However, not all the reductions in access charges would be fully offset. We anticipate additional state legislative and regulatory pressure to lower intrastate access rates.

Some state legislatures and regulators are also examining the provision of telecommunications services to previously unserved areas. Since many unserved areas are located in rural markets, we could be required to expand our service territory into some of these areas.

Recent and Potential Regulatory Developments

Wireline and wireless carriers are required to provide local number portability (LNP). LNP is the ability of customers to switch from a wireline or wireless carrier to another wireline or wireless carrier without changing telephone numbers. We are 100% LNP capable in our largest markets and over 99% of our exchanges are LNP capable. We will upgrade the remaining exchanges in response to bona fide requests as required by FCC regulations.

In 1994, Congress passed the Communications Assistance for Law Enforcement Act (CALEA) to ensure that telecommunication networks can meet law enforcement wiretapping needs. Our company was fully compliant, for all TDM voice services, by June 2006. In June 2006, the FCC issued an order addressing the assistance capabilities required, pursuant to section 103 of the CALEA law, for facilities-based broadband Internet access providers and providers of interconnected VOIP. Frontier expects to be fully compliant in 2007 as required by the order.

The FCC and Congress may address issues involving inter-carrier compensation, the universal service fund and internet telephony in 2007. The FCC adopted a Further Notice of Proposed Rulemaking (FNPRM) addressing inter-carrier compensation on February 10, 2005. Some of the proposals being discussed with respect to inter-carrier compensation, such as "bill and keep" (under which switched access charges would be reduced or eliminated), could reduce our access revenues and our profitability. The FCC requested additional comments on intercarrier compensation proposals in late 2006. The universal service fund is under pressure as local exchange companies lose access lines and more entities, such as wireless companies, seek to receive monies from the fund. The rules surrounding the eligibility of Competitive Eligible Telecommunication Carriers, such as wireless companies, to receive universal service funds are expected to be clarified by the Federal-State Joint Board on Universal Service and the clarification of the rules may heighten the pressures on the fund. In addition the Joint Board requested comments, on August 8, 2006, on the merits of using reverse auctions to determine the distribution of high-cost Universal Service support. Changes in the funding or payout rules of the universal service fund could further reduce our subsidy revenues and our profitability. As discussed in MD&A, our access and subsidy revenues are important to our cash flows and our access revenues declined in 2006 compared to 2005. Our access and subsidy revenues are both likely to decline in 2007.

The development and growth of internet telephony (also known as VOIP) by cable and other companies have increased the importance of regulators at both the federal and state levels addressing whether such services are subject to the same or different regulatory and financial models as traditional telephony. The FCC has concluded that certain VOIP services are jurisdictionally interstate in nature and are thereby exempt from state telecommunications regulations. The FCC has not addressed other related issues, such as: whether or under what terms VOIP traffic may be subject to intercarrier compensation; and whether VOIP services are subject to general state requirements relating to taxation and general commercial business requirements. The FCC has stated its intent to address these open questions in subsequent orders in its ongoing "IP-Enabled Services Proceeding," which opened in February 2004. Internet telephony may have an advantage over our traditional services if it remains less regulated. We are actively participating in the FCC's consideration of all these issues. On June 3, 2005, the FCC

issued an order requiring VOIP services interconnected to the public switched telephone network to include E-911 calling capabilities by November 28, 2005. Subsequently, the FCC issued a number of public notices detailing the steps that could be considered sufficient interim compliance. The FCC stated in a public notice that providers not in full compliance would not be required to disconnect existing subscribers but would be expected not to connect new subscribers in areas where they are not transmitting 911 calls in full compliance with the rules. On September 23, 2005, the FCC issued an order stating that both interconnected VOIP services and broadband internet access services will be required to comply with CALEA by May 12, 2007. On June 27, 2006, the FCC issued an order stating that revenues from certain VOIP services are subject to contributing to the universal service fund. Both the VOIP E-911 order and the CALEA order have been fully litigated in the FCC's reconsideration petition and appealed before federal courts; the result is that VOIP will be required to comply with both of these regulatory mandates.

Some state regulators (including New York and Illinois) have in the past considered imposing on regulated companies (including us) cash management practices that could limit the ability of a company to transfer cash between its subsidiaries or to its parent company. None of the existing state requirements materially affect our cash management but future changes by state regulators could affect our ability to freely transfer cash within our consolidated companies.

Competition

Competition in the telecommunications industry is intense and increasing. We experience competition from many communications service providers including cable operators, wireless carriers, VOIP providers, long distance providers, competitive local exchange carriers, internet providers and other wireline carriers. We believe that competition will continue to intensify in 2007 across all products and in all of our markets. Our Frontier business experienced erosion in access lines and switched access minutes of use in 2006 as a result of competition. Competition in our markets may result in reduced revenues in 2007.

We are responding to this competitive environment with new product offers and by bundling products and services together with an end user contract term commitment. Revenues from data services and packages continue to increase as a percentage of our total revenues. There will continue to be price and margin pressures in our business that may result in less revenues and profitability.

The telecommunications industry is undergoing significant changes. The market is extremely competitive, resulting in lower prices, and consumers are changing behavior, such as using wireless in place of wireline services and using e-mail instead of making calls. These trends are likely to continue and result in a challenging revenue environment. These factors could also result in more bankruptcies in the sector and therefore affect our ability to collect money owed to us by bankrupt carriers.

Divestiture of Public Utilities Services

In the past we provided public utilities services including natural gas transmission and distribution, electric transmission and distribution, water distribution and wastewater treatment services to primarily rural and suburban customers throughout the United States. In 1999, we announced a plan of divestiture for our public utilities services properties. Since then, we have divested all of our public utility operations for an aggregate of \$1.9 billion. Our last public utility operation (Vermont Electric) was sold in April of 2004.

We have retained a potential payment obligation associated with our previous electric utility activities in the State of Vermont. The Vermont Joint Owners (VJO), a consortium of 14 Vermont utilities, including us, entered into a purchase power agreement with Hydro-Quebec in 1987. The agreement contains "step-up" provisions which state that if any VJO member defaults on its purchase obligation under the contract to purchase power from Hydro-Quebec, then the other VJO participants will assume responsibility for the defaulting party's share on a pro-rata basis. Our pro-rata share of the purchase power obligation is 10%. If any member of the VJO defaults on its obligations under the Hydro-Quebec agreement, the remaining members of the VJO, including us, may be required to pay for a substantially larger share of the VJO's total power purchase obligation for the remainder of the agreement (which runs through 2015). Paragraph 13 of FIN No. 45 requires that we disclose "the maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee." Paragraph 13 also states that we must make such disclosure "... even if the likelihood of the guarantor's having to make any payments under the guarantee is remote..." As noted above, our obligation only arises as a result of default by another VJO member, such as upon bankruptcy. Therefore, to satisfy the "maximum potential amount" disclosure requirement we must assume that all members of the VJO simultaneously default, a highly unlikely scenario given that the two members of the VJO that have the largest potential payment obligations are publicly traded with credit ratings that are equal to or superior to ours, and that all VJO members are regulated utility providers with regulated cost recovery. Regardless, despite the remote chance that such an event could occur, or that the State of Vermont could or would allow such an event, assuming that all the members of the VJO defaulted on January 1, 2008 and remained in default for the duration of the contract (another 7 years), we estimate that our undiscounted purchase obligation for 2008

through 2015 would be approximately \$1.1 billion. In such a scenario we would then own the power and could seek to recover our costs. We would do this by seeking to recover our costs from the defaulting members and/or reselling the power to other utility providers or the northeast power grid. There is an active market for the sale of power. We could potentially lose money if we were unable to sell the power at cost. We caution that we cannot predict with any degree of certainty any potential outcome.

Divestiture of Electric Lightwave LLC

In 2006, we sold our CLEC business, Electric Lightwave LLC (ELI) for \$255.3 million (including the sale of associated real estate) in cash plus the assumption of approximately \$4.0 million in capital lease obligations. We recognized a pre-tax gain on the sale of ELI of approximately \$116.7 million. Our after-tax gain on the sale was \$71.6 million. Our cash liability for taxes as a result of the sale is expected to be approximately \$5.0 million due to the utilization of existing tax net operating losses on both the federal and state level.

Segment Information

With the 2006 sale of our CLEC (ELI), we currently operate in only one reportable segment.

Financial Information about Foreign and Domestic Operations and Export Sales

We have no foreign operations.

General

Order backlog is not a significant consideration in our businesses. We have no material contracts or subcontracts that may be subject to renegotiation of profits or termination at the election of the Federal government. We hold no patents, licenses or concessions that are material.

Employees

As of December 31, 2006, we had 5,446 employees. 2,996 of our employees are affiliated with a union. The number of union employees covered by agreements set to expire during 2007 is 1,526. We consider our relations with our employees to be good.

Available Information

We are subject to the informational requirements of the Securities Exchange Act of 1934. Accordingly, we file periodic reports, proxy statements and other information with the Securities and Exchange Commission (SEC). Such reports, proxy statements and other information may be obtained by visiting the Public Reference Room of the SEC at 100 F Street, NE, Washington, D.C. 20549 or by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site (www.sec.gov) that contains reports, proxy and information statements and other information regarding the Company and other issuers that file electronically. Material filed by us can also be inspected at the offices of the New York Stock Exchange, Inc. (NYSE), 20 Broad Street, New York, NY 10005, on which our common stock is listed. On June 26, 2006, our Chief Executive Officer submitted the annual certification required by Section 303A.12(a) of the NYSE Listed Company Manual. In addition, the certifications of our Chief Executive Officer and Chief Financial Officer required under Section 302 of the Sarbanes-Oxley Act of 2002 are included as exhibits to this Form 10-K.

We also make available on our website, or in printed form upon request, free of charge, our Corporate Governance Guidelines, Code of Business Conduct and Ethics, and the charters for the Audit, Compensation, and Nominating and Corporate Governance committees of the Board of Directors. Stockholders may request printed copies of these materials by writing to: 3 High Ridge Park, Stamford, Connecticut 06905 Attention: Corporate Secretary. Our website address is www.czn.net.

Item 1A. Risk Factors

Before you make an investment decision with respect to our securities, you should carefully consider all the information we have included or incorporated by reference in this Form 10-K and our subsequent periodic filings with the SEC. In particular, you should carefully consider the risk factors described below and read the risks and uncertainties related to "forward-looking statements" as set forth in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of this Form 10-K. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties that are not presently known to us or that we currently deem immaterial or that are not specific to us, such as general economic conditions, may also adversely affect our business and operations.

Risks Related to Competition and Our Industry

We face intense competition, which could adversely affect us.

The telecommunications industry is extremely competitive and competition is increasing. The traditional dividing lines between long distance, local, wireless, cable and internet services are becoming increasingly blurred. Through mergers and various service expansion strategies, services providers are striving to provide integrated solutions both within and across geographic markets. Our competitors include CLECs and other providers (or potential providers) of services, such as internet service providers, or ISPs, wireless companies, neighboring incumbents, VOIP providers such as Vonage and cable companies that may provide services competitive with ours or services that we intend to introduce. Competition is intense and increasing and we cannot assure you that we will be able to compete effectively. For example, at December 31, 2006 we had 111,000 fewer access lines than we had at December 31, 2005 and we believe wireless and cable telephony providers have increased their market share in our markets. We expect to continue to lose access lines and that competition with respect to all our products and services will increase.

We expect competition to intensify as a result of the entrance of new competitors and the development of new technologies, products and services. We cannot predict which of the many possible future technologies, products or services will be important to maintain our competitive position or what expenditures will be required to develop and provide these technologies, products or services. Our ability to compete successfully will depend on marketing and on our ability to anticipate and respond to various competitive factors affecting the industry, including a changing regulatory environment that may affect our competitors and us differently, new services that may be introduced, changes in consumer preferences, demographic trends, economic conditions and pricing strategies by competitors. Increasing competition may reduce our revenues and increase our costs as well as require us to increase our capital expenditures and thereby decrease our cash flow.

Some of our competitors have superior resources, which may place us at a cost and price disadvantage.

Some of our current and potential competitors have market presence, engineering, technical and marketing capabilities, and financial, personnel and other resources substantially greater than ours. In addition, some of our competitors can raise capital at a lower cost than we can. Consequently, some competitors may be able to develop and expand their communications and network infrastructures more quickly, adapt more swiftly to new or emerging technologies and changes in customer requirements, take advantage of acquisition and other opportunities more readily and devote greater resources to the marketing and sale of their products and services than we can. Additionally, the greater brand name recognition of some competitors may require us to price our services at lower levels in order to retain or obtain customers. Finally, the cost advantages of some competitors may give them the ability to reduce their prices for an extended period of time if they so choose.

Risks Related to Our Business

Decreases in certain types of our revenues will impact our profitability.

Our Frontier business has been experiencing declining access lines, switched access minutes of use, long distance prices and related revenues because of economic conditions, increasing competition, changing consumer behavior (such as wireless displacement of wireline use, email use, instant messaging and increasing use of VOIP), technology changes and regulatory constraints. These factors are likely to cause our local network service, switched network access, long distance and subsidy revenues to continue to decline, and these factors, together with our increasing employee costs, and the potential need to increase our capital spending, may cause our cash generated by operations to decrease.

We may be unable to grow our revenue and cash flow despite the initiatives we have implemented.

We must produce adequate cash flow that, when combined with funds available under our revolving credit facility, will be sufficient to service our debt, fund our capital expenditures, pay

our taxes and maintain our current dividend policy. We expect that our cash taxes will increase substantially in 2007 as we begin to have lower amounts of tax operating losses. We have implemented several growth initiatives, including increasing our marketing promotion/expenditures and launching new products and services with a focus on areas that are growing or demonstrate meaningful demand such as wireline and wireless high-speed internet. There is no assurance that these initiatives will result in an improvement in our financial position or our results of operations.

We may complete a significant business combination or other transaction that could increase our shares outstanding, affect our debt, result in a change in control, or all of the above.

From time to time we evaluate potential acquisitions and other arrangements, such as the Commonwealth acquisition, that would extend our geographic markets, expand our services, enlarge the capacity of our networks or increase the types of services provided through our networks. If we complete any acquisition or other arrangement, we may require additional financing that could result in an increase in our shares outstanding and/or debt, result in a change in control, or all of the above. There can be no assurance that we will enter into any transaction.

Our business is sensitive to the creditworthiness of our wholesale customers.

We have substantial business relationships with other telecommunications carriers for whom we provide service. During the past few years, several of our customers have filed for bankruptcy. While these bankruptcies have not had a material adverse effect on our business to date, future bankruptcies in our industry could result in our loss of significant customers, more price competition and uncollectible accounts receivable. As a result, our revenues and results of operations could be materially and adversely affected.

Risks Related to Liquidity, Financial Resources, and Capitalization

Substantial debt and debt service obligations may adversely affect us.

We have a significant amount of indebtedness. We may also obtain additional long-term debt and working capital lines of credit to meet future financing needs, subject to certain restrictions under our existing indebtedness, which would increase our total debt.

The significant negative consequences on our financial condition and results of operations that could result from our substantial debt include:

- * limitations on our ability to obtain additional debt or equity financing;
- * instances in which we are unable to meet the financial covenants contained in our debt agreements or to generate cash sufficient to make required debt payments, which circumstances have the potential of accelerating the maturity of some or all of our outstanding indebtedness;
- * the allocation of a substantial portion of our cash flow from operations to service our debt, thus reducing the amount of our cash flow available for other purposes, including operating costs, capital expenditures and dividends that could improve our competitive position or results of operations;
- * requiring us to sell debt or equity securities or to sell some of our core assets, possibly on unfavorable terms, to meet payment obligations;
- * compromising our flexibility to plan for, or react to, competitive challenges in our business and the communications industry; and
- * the possibility of our being put at a competitive disadvantage with competitors who do not have as much debt as us, and competitors who may be in a more favorable position to access additional capital resources.

We will require substantial capital to upgrade and enhance our operations.

Replacing or upgrading our infrastructure will result in significant capital expenditures. If this capital is not available when needed, our business will be adversely affected. Increasing

competition, offering new services, improving the capabilities or reducing the maintenance costs of our plant may cause our capital expenditures to increase in the future. In addition, our ongoing annual dividend of \$1.00 per share under our current policy utilizes a significant portion of our cash generated by operations and therefore limits our operating and financial flexibility and our ability to significantly increase capital expenditures. While we believe that the amount of our dividend will allow for adequate amounts of cash flow for capital spending and other purposes, any material reduction in cash generated by operations and any increases in capital expenditures, interest expense or cash taxes would reduce the amount of cash generated in excess of dividends. Losses of access lines, the effects of increased competition, lower subsidy and access revenues and the other factors described above may reduce our cash generated by operations and may require us to increase capital expenditures. In addition, we expect our cash paid for taxes to increase significantly over the next several years.

Risks Related to Regulation

The access charge revenues we receive may be reduced at any time.

A significant portion of our revenues (\$263.0 million or 13% in 2006) is derived from access charges paid by IXCs for services we provide in originating and terminating intrastate and interstate traffic. The amount of access charge revenues we receive for these services is regulated by the FCC and state regulatory agencies. Recent rulings regarding access charges have lowered the amount of revenue we receive from this source. The FCC has an open proceeding to address reform to access charges and other intercarrier compensation. A material reduction in the access revenues we receive would adversely affect our financial results.

We are reliant on support funds provided under federal and state laws.

We receive a portion of our revenue (\$165.0 million or 8% in 2006) from federal and state subsidies, including the federal high cost fund, federal local switching support fund, federal USF surcharge and various state funds. FCC and state regulators are currently considering a number of proposals for changing the manner in which eligibility for federal subsidies is determined as well as the amounts of such subsidies. The FCC is also reviewing the mechanism by which subsidies are funded. We cannot predict when or how these matters will be decided nor the effect on our subsidy revenue.

The federal high cost fund is our largest source of subsidy revenue (approximately \$59.0 million in 2006). We currently expect that as a result of both an increase in the national average cost per loop and a decrease in our cost structure, there is likely to be a decrease in the subsidy revenue earned in 2007 through the federal high cost support fund and such decrease may be significant in relation to the total amount of our subsidy revenue.

In addition, approximately \$37.1 million or 2% of our revenue represents a surcharge to customers (local, long distance and IXC) which is remitted to the FCC and recorded as an expense in "other operating expenses". The FCC revised the calculation for this surcharge by eliminating high speed internet connections from the calculation effective August 15, 2006. As a result, we expect this surcharge revenue (and its associated expense) to decrease in 2007 and such decrease may be significant in relation to the total amount of our subsidy revenue.

Our company and industry are highly regulated, imposing substantial compliance costs and restricting our ability to compete in our target markets.

As an incumbent, we are subject to significant regulation from federal, state and local authorities. This regulation restricts our ability to change our rates, especially on our basic services, and imposes substantial compliance costs on us. Regulation restricts our ability to compete and, in some jurisdictions, it may restrict how we are able to expand our service offerings. In addition, changes to the regulations that govern us may have an adverse effect upon our business by reducing the allowable fees that we may charge, imposing additional compliance costs, or otherwise changing the nature of our operations and the competition in our industry.

Customers are now permitted to retain their wireline number when switching to another service provider. This is likely to increase the number of our customers who decide to disconnect their service from us. Other pending rulemakings, including those relating to intercarrier compensation, universal service and VOIP regulations, could have a substantial adverse impact on our operations.

Risks Related to the Acquisition of Commonwealth

There is no assurance that the acquisition of Commonwealth will occur.

While we have received the requisite Hart-Scott Rodino and FCC approvals, the acquisition of Commonwealth is still subject to a number of conditions, including the approval of the Pennsylvania Public Utilities Commission, or Pennsylvania PUC.

The integration of Commonwealth following the acquisition may present significant challenges.

We may face significant challenges in combining Commonwealth's operations into our operations in a timely and efficient manner and in retaining key Commonwealth personnel. The failure to integrate successfully and to manage successfully the challenges presented by the integration process may result in us not achieving the anticipated benefits of the acquisition. In addition, we and Commonwealth expect to incur costs associated with transaction fees and other costs related to the acquisition. We will also incur integration and restructuring costs following the completion of the acquisition as we integrate the businesses of Commonwealth with those of ours. Although we expect that the realization of efficiencies related to the integration of the business will offset incremental transaction, integration and restructuring costs over time, we cannot give any assurance that this net benefit will be achieved.

Risks Related to Technology

In the future as competition intensifies within our markets, we may be unable to meet the technological needs or expectations of our customers, and may lose customers as a result.

The telecommunications industry is subject to significant changes in technology. If we do not replace or upgrade technology and equipment, we will be unable to compete effectively because we will not be able to meet the needs or expectations of our customers. Replacing or upgrading our infrastructure could result in significant capital expenditures.

In addition, rapidly changing technology in the telecommunications industry may influence our customers to consider other service providers. For example, we may be unable to retain customers who decide to replace their wireline telephone service with wireless telephone service. In addition, VOIP technology, which operates on broadband technology, now provides our competitors with a low-cost alternative to provide voice services to our customers.

Item 1B. Unresolved Staff Comments None.

Item 2. Properties

Our principal corporate offices are located in leased premises at 3 High Ridge Park, Stamford, Connecticut 06905.

An operations support office is currently located in leased premises at 180 South Clinton Avenue, Rochester, New York 14646. In addition, we lease and own space in our operating markets throughout the United States.

Our telephone properties include: connecting lines between customers' premises and the central offices; central office switching equipment; fiber-optic and microwave radio facilities; buildings and land; and customer premise equipment. The connecting lines, including aerial and underground cable, conduit, poles, wires and microwave equipment, are located on public streets and highways or on privately owned land. We have permission to use these lands pursuant to local governmental consent or lease, permit, franchise, easement or other agreement.

Discontinued Operations On July 31, 2006, we sold our CLEC business Electric Lightwave LLC (ELI) for \$255.3 million (including a later sale of associated real estate) in cash plus the assumption of approximately \$4.0 million in capital lease obligations. We recognized a pre-tax gain on the sale of ELI of approximately \$116.7 million. Our after-tax gain on the sale was \$71.6 million. Our cash liability for taxes as a result of the sale is expected to be approximately \$5.0 million due to the utilization of existing tax net operating losses on both the federal and state level.

On March 15, 2005, we completed the sale of Conference Call USA, LLC (CCUSA) for \$43.6 million in cash. The pre-tax gain on the sale of CCUSA was \$14.1 million. Our after-tax gain was \$1.2 million. The book income taxes recorded upon sale are primarily attributable to a low tax basis in the assets sold.

Critical Accounting Policies and Estimates

We review all significant estimates affecting our consolidated financial statements on a recurring basis and record the effect of any necessary adjustment prior to their publication. Uncertainties with respect to such estimates and assumptions are inherent in the preparation of financial statements; accordingly, it is possible that actual results could differ from those estimates and changes to estimates could occur in the near term. The preparation of our financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of the contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Estimates and judgments are used when accounting for allowance for doubtful accounts, impairment of long-lived assets, intangible assets, depreciation and amortization, employee benefit plans, income taxes, contingencies, and pension and postretirement benefits expenses among others.

Management has discussed the development and selection of these critical accounting estimates with the Audit Committee of our Board of Directors and our Audit Committee has reviewed our disclosures relating to them.

Telecommunications Bankruptcies

Our estimate of anticipated losses related to telecommunications bankruptcies is a "critical accounting estimate." We have significant on-going normal course business relationships with many telecom providers, some of which have filed for bankruptcy. We generally reserve approximately 95% of the net outstanding pre-bankruptcy balances owed to us and believe that our estimate of the net realizable value of the amounts owed to us by bankrupt entities is appropriate. In 2006 and 2005, we had no "critical estimates" related to telecommunications bankruptcies.

Asset Impairment

In 2006 and 2005, we had no "critical estimates" related to asset impairments.

Depreciation and Amortization

The calculation of depreciation and amortization expense is based on the estimated economic useful lives of the underlying property, plant and equipment and identifiable intangible assets.

(b) Results of Operations

REVENUE

Revenue is generated primarily through the provision of local, network access, long distance and data services. Such services are provided under either a monthly recurring fee or based on usage at a tariffed rate and is not dependent upon significant judgments by management, with the exception of a determination of a provision for uncollectible amounts.

Consolidated revenue increased \$8.3 million, from \$2.017 billion in 2005 to \$2.025 billion in 2006.

Consolidated revenue decreased \$5.3 million in 2005. The decrease in 2005 is

primarily due to the sale in 2004 of our electric utility property, partially offset by an increase of \$4.4 million in telecommunications revenue. Our electric utility contributed \$9.7 million of revenue in 2004.

In July 2006, we sold our CLEC segment (ELI) to Integra. As a result, we have reclassified ELI's results of operations as discontinued operations in our consolidated statements of operations and restated prior periods.

In June 2005, the FASB issued EITF No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," which provides new guidance on how general partners in a limited partnership should determine whether they control a limited partnership. The Company has applied the provisions of EITF No. 04-5 retrospectively and consolidated Mohave for all periods presented.

On March 15, 2005, we completed the sale of our conferencing service business, CCUSA. As a result of the sale, we have classified CCUSA's results of operations as discontinued operations in our consolidated statement of operations and restated prior periods.

Change in the number of our access lines is important to our revenue and profitability. We have lost access lines primarily because of competition, changing consumer behavior, economic conditions, changing technology, and by some customers disconnecting second lines when they add high-speed internet or cable modem service. We lost approximately 111,000 access lines during 2006, but added approximately 75,100 high-speed internet subscribers during this same period. We lost 98,800 residential customer lines and 12,200 non-residential customer lines in 2006. The non-residential line losses were principally in Rochester, New York, while the residential losses were throughout our markets. We expect to continue to lose access lines but to increase high-speed internet subscribers during 2007. A continued loss of access lines, combined with increased competition and the other factors discussed in MD&A, may cause our revenues, profitability and cash flows to decrease in 2007.

TELECOMMUNICATIONS REVENUE

(\$ in thousands)			2006				
2005	2004						
			Amount	\$ Change	% Change	Amount	\$
Change	% Change	Amount					
Local services			\$ 809,584	\$ (20,101)	-2%	\$ 829,685	\$
(21,392)	-3%	\$ 851,077					
Access services			427,959	(3,380)	-1%	431,339	
(25,589)	-6%	456,928					
Long distance services			153,272	(16,224)	-10%	169,496	
(14,127)	-8%	183,623					
Data and internet services			424,209	58,596	16%	365,613	
51,835	17%	313,778					
Directory services			114,138	1,046	1%	113,092	
2,469	2%	110,623					
Other			96,205	(11,611)	-11%	107,816	
11,202	12%	96,614					
ILEC revenue			\$2,025,367	\$ 8,326	0%	\$2,017,041	\$
4,398	0%	\$2,012,643					

Local Services

Local services revenue for the year ended December 31, 2006 decreased \$20.1 million or 2%, as compared with the prior year. Local revenue decreased \$25.9

million primarily due to continued losses of access lines partially offset by a local rate increase on some of our Rochester residential access lines effective August 2006. 2005 reflected a reserve of \$4.0 million associated with a state rate of return limitation on earnings. Enhanced services revenue increased \$5.8 million, primarily due to sales of additional feature packages. Economic conditions and/or increasing competition could make it more difficult to sell our packages and bundles and cause us to lower our prices for those products and services, which would adversely affect our revenues and profitability and cash flow.

Local services revenue for the year ended December 31, 2005 decreased \$21.4 million or 3%, as compared with the prior year. This decline is comprised of \$18.8 million related to the continued loss of access lines and \$4.0 million related to a reserve associated with state rate of return limitations on earnings. Enhanced services revenue increased \$5.9 million, as compared with the prior year, primarily due to sales of additional product packages.

Access Services

Access services revenue for the year ended December 31, 2006 decreased \$3.4 million or 1%, as compared with the prior year. Access services includes both switched revenue and subsidy payments. Switched access revenue decreased \$13.9 million to \$263.4 million. Approximately \$24.0 million of the switched access decline was attributable to a decline in minutes of use related to access line losses. This decline was offset by approximately \$9.3 million of disputed carrier activity resolved in the Company's favor during the fourth quarter of 2006. Subsidies revenue increased \$10.5 million to \$164.6 million primarily due to increased receipts from the federal high cost fund due to higher costs in the base year, as well as increased receipts from state high cost funds.

Access services revenue for the year ended December 31, 2005 decreased \$25.6 million or 6%, as compared with the prior year. Switched access revenue decreased \$9.7 million, as compared with the prior year period, primarily due to a decline in minutes of use. Access service revenue includes subsidy payments we receive from federal and state agencies. Subsidy revenue decreased \$15.9 million primarily due to decreased Universal Service Fund (USF) support of \$19.2 million because of increases in the national average cost per loop (NACPL) and a decrease of \$2.0 million related to changes in measured factors, partially offset by an increase of \$6.4 million in USF surcharge rates.

Increases in the number of Competitive Eligible Telecommunications Companies (including wireless companies) receiving federal subsidies, among other factors, may lead to further increases in the NACPL, thereby resulting in decreases in our subsidy revenue in the future. The FCC and state regulators are currently considering a number of proposals for changing the manner in which eligibility for federal subsidies is determined as well as the amounts of such subsidies. The FCC is also reviewing the mechanism by which subsidies are funded.

Additionally, the FCC has an open proceeding to address reform to access charges and other intercarrier compensation. We cannot predict when or how these matters will be decided nor the effect on our subsidy or access revenues. Future reductions in our subsidy and access revenues are not expected to be accompanied by proportional decreases in our costs, so any further reductions in those revenues will directly affect our profitability and cash flows. We currently expect that as a result of an increase in the national average cost per loop, a decrease in our cost structure and the elimination of high speed internet from the calculation of the FCC's USF surcharge (which has a corresponding decrease in operating expenses) there is likely to be a decrease in the total subsidy revenue earned in 2007 and such decrease may be significant in relation to the total amount of our subsidy revenue.

Long Distance Services

Long distance services revenue for the years ended December 31, 2006 and 2005 decreased

\$16.2 million or 10% in 2006 and \$14.1 million or 8% in 2005, primarily due to a decline in the average rate per minute. Our long distance minutes of use increased during 2006. We have actively marketed bundles or unlimited use of long distance minutes particularly with our packages of multiple services. The sale of bundled and unlimited minutes has resulted in an increase in minutes used by our long distance customers and has had the effect of lowering our overall average rate per minute billed. Our long distance revenues may continue to decrease in the future due to lower rates and/or minutes of use. Competing services such as wireless, VOIP and cable telephony are resulting in a loss of customers, minutes of use and further declines in the rates we charge our customers. We expect these factors will continue to adversely affect our long distance revenues during 2007.

Data and Internet Services

Data and internet services revenue for the years ended December 31, 2006 and 2005 increased \$58.6 million, or 16%, and \$51.8 million, or 17%, respectively, as compared with the prior year primarily due to growth in data and high-speed internet services. The number of the Company's high-speed internet subscribers has increased by more than 75,000 or 24% since December 31, 2005. Data & Internet services also includes revenue from data transmission services to other carriers and high-volume commercial customers with dedicated high-capacity circuits like DS-1's and DS-3's. Revenue from these dedicated high-capacity circuits increased \$9.1 million in 2006 and \$15.0 million in 2005, primarily due to growth in those circuits.

Directory Services Directory revenue for the years ended December 31, 2006 and 2005 increased \$1.0 million, or 1%, and \$2.5 million, or 2%, respectively, as compared with the prior year due to growth in yellow pages advertising.

Other

Other revenue for the year ended December 31, 2006 decreased \$11.6 million or 11%, as compared with the prior year primarily due to an increase in bad debt expense of \$7.5 million and decreases of \$2.3 million for promotional credits, \$1.8 million in sales of customer premise equipment (CPE) and \$1.6 million in "bill and collect" fee revenue. The decreases were partially offset by an increase of \$2.5 million for cellular roaming revenue of the Mohave Cellular Limited Partnership.

Other revenue for the year ended December 31, 2005 increased \$11.2 million, or 12%, compared with the prior year primarily due to a \$4.8 million decrease in bad debt expense, a \$4.1 million increase in cellular revenue and a \$1.8 million increase related to sales of television service.

ELECTRIC REVENUE

We sold our Vermont electric division on April 1, 2004. Electric revenue for the year ended December 31, 2004 was \$9.7 million. We have sold all of our electric operations and as a result will have no operating results in future periods for these businesses.

(\$ in thousands)			COST OF SERVICES			
			2005		2006	
2005	2004	Amount	\$ Change	% Change	Amount	\$
Change	% Change	Amount				
Network access		\$ 171,247	\$ 14,425	9%	\$ 156,822	\$
1,431	1%	\$ 155,391				
Electric energy and fuel		-	-		-	
oil purchased						
(5,523)	-100%	5,523				
		\$ 171,247	\$ 14,425	9%	\$ 156,822	\$
(4,092)	-3%	\$ 160,914				

Network access

Network access expenses for the years ended December 31, 2006 and 2005 increased \$14.4 million and \$1.4 million, or 9%, and 1%, respectively, as compared with the prior year period. In the fourth quarter of 2006, we expensed \$9.7 million of promotional costs associated with a



Form 10-K

Consolidated Communications Illinois Holdings, Inc. - CNSL

Filed: March 09, 2007 (period: December 31, 2006)

Annual report which provides a comprehensive overview of the company for the past year

PART I

Item 1. Business

“Consolidated Communications” or the “Company” refers to Consolidated Communications Holdings, Inc. alone or with its wholly owned subsidiaries, as the context requires. When this report uses the words “we,” “our,” or “us,” they refer to the Company and its subsidiaries unless the context otherwise requires.

Website Access to Securities and Exchange Commission Reports

The Company’s Internet website can be found at www.consolidated.com. The Company makes available free of charge on or through its website its annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as practicable after the Company files them with, or furnishes them to, the Securities and Exchange Commission.

Overview

Consolidated Communications is an established rural local exchange telephone company that provides communications services to residential and business customers in Illinois and Texas. We offer a wide range of telecommunications services, including local and long distance service, custom calling features, private line services, dial-up and high-speed Internet access, digital TV, carrier access services, network capacity services over our regional fiber optic network, and directory publishing. In addition, we operate a number of complementary businesses, including telemarketing and order fulfillment; telephone services to county jails and state prisons; equipment sales; operator services; and mobile services.

We are the 15th largest local telephone company in the United States. As of December 31, 2006, we had approximately 233,689 local access lines, 52,732 high-speed Internet subscribers (which we refer to as digital subscriber lines, or DSL) and 6,954 Internet Protocol digital television (or IPTV) subscribers.

For the years ended December 31, 2006 and 2005, we had \$320.8 million and \$321.4 million of revenues, respectively. In addition, we generated net income of \$13.3 million for the year ended December 31, 2006 and had a net loss of \$4.5 million for 2005. As of December 31, 2006, we had \$594.0 million of total long-term debt, an accumulated deficit of \$87.4 million and stockholders’ equity of \$115.0 million.

History of the Company

Founded in 1894 as the Mattoon Telephone Company by the great-grandfather of our Chairman, Richard A. Lumpkin, we began as one of the nation’s first independent telephone companies. After several subsequent acquisitions, the Mattoon Telephone Company was incorporated as Illinois Consolidated Telephone Company, or ICTC, on April 10, 1924. On September 24, 1997, McLeodUSA acquired ICTC and all related businesses from the Lumpkin family.

In December 2002, Mr. Lumpkin and two private equity firms, Spectrum Equity and Providence Equity, purchased the capital stock and assets of ICTC and several related businesses back from McLeodUSA.

On April 14, 2004, we acquired TXU Communications Ventures Company, or TXUCV, from TXU Corporation. TXUCV owned rural telephone operations in Lufkin, Conroe, and Katy, Texas, which through its predecessor companies had been operating in those markets for over 90 years. This acquisition approximately tripled the size of the Company.

On July 27, 2005, we completed the initial public offering, or IPO, of our common stock. Concurrent with the IPO, Spectrum Equity sold its entire investment and Providence Equity sold 50 percent of its investment in Consolidated Communications. On July 28, 2006, the Company repurchased the remaining shares owned by Providence Equity.

Our Strengths

Stable Local Telephone Business

We are the incumbent local telephone company in the rural communities we serve, and demand for local telephone services from our residential and business customers has been stable despite changing economic conditions. We operate in a favorable regulatory environment, and competition in our markets is limited. As a result of these favorable characteristics, the cash flow generated by our local telephone business is relatively consistent from year to year. Our long-standing relationship with our local telephone customers provides us with an opportunity to pursue increased revenue per access line by selling additional services to existing customers through a bundling strategy, such as our triple play offering of local voice service, DSL and IPTV.

Attractive Markets and Limited Competition

The geographic areas in which our rural telephone companies operate are characterized by a balanced mix of stable, insular territories in which we have limited competition and growing suburban areas. Historically, we have had limited competition for basic voice services from wireless carriers and non-facilities based providers using Voice Over Internet Protocol, or VOIP. Cable providers have also started offering a voice product. As of December 31, 2006, Mediacom is the only cable operator to have launched a voice product in our markets, by our estimate overlapping approximately 15% of our total access lines.

Our Lufkin, Texas and central Illinois markets have experienced only nominal population growth over the past decade. As of December 31, 2006, 121,554, or approximately 52.0%, of our local access lines were located in these markets. We have experienced limited competition in these markets because the low customer density and high residential component have discouraged the significant capital investment required to offer service over a competing network.

Our Conroe, Texas and Katy, Texas markets are suburban areas located on the outskirts of the Houston metropolitan area. As of December 31, 2006, 112,135, or approximately 48.0%, of our local access lines were located in these markets. They have experienced above-average population and business employment growth over the past decade as compared to Texas and the United States as a whole. According to the most recent census, the median household income in the primary county in our Conroe market was over \$50,000 per year and in our Katy market was over \$60,000 per year, both significantly higher than the median household income in Texas of \$39,927 per year.

Technologically Advanced Network

We have invested significantly over the last several years in building a technologically advanced network capable of delivering a broad array of reliable, high quality voice and data and video services to our customers on a cost-effective basis. For example, approximately 92% of our total local access lines were DSL-capable as of December 31, 2006. Of our DSL capable lines, approximately 80% are capable of speeds of 6 mega bits per second (Mbps) or greater. This is made possible by leveraging our Internet Protocol, or IP, backbone network in Illinois and Texas. We believe this IP network will position us with a lower cost, better quality and flexible platform that will enable the development and delivery of new broadband applications to our customers. The service options we are able to provide over our existing network allow us to generate additional revenues per customer. For example, other than the provision of success-based set-top boxes for subscribers, we believe our current network is capable of supporting increased IPTV subscribers with limited additional network preparation.

Broad Service Offerings and Bundling of Services

We offer our residential and business customers a single point of contact for access to a broad array of voice, data, and video services. We provide local and long distance service, multiple speeds or tiers of DSL service and a robust IPTV video offering with over 200 all digital channels. We also offer custom calling services, carrier access services, network capacity services and directory publishing.

We generate additional revenues per customer by bundling services. Bundling enables us to provide a more complete package of services to our customers, which increases our average revenue per user, or ARPU, while adding additional value for the consumer. We also believe the bundling of services results in increased customer loyalty and higher customer retention. As of December 31, 2006, we had 43,175 customers who subscribed to service bundles that included local service, custom calling features, DSL and IPTV. Collectively, this represents an increase of approximately 17.9 % over the number of customers who subscribed to service bundles as of December 31, 2005.

Favorable Regulatory Environment

We benefit from federal and Texas state subsidies designed to promote widely available, quality telephone service at affordable prices in rural areas, which is also referred to as universal service. For the year ended December 31, 2006 we received \$28.1 million in payments from the federal universal service fund and \$19.5 million from the Texas universal service fund. In the aggregate, these payments comprised 14.8 % of our revenues for the year ended December 31, 2006. For the year ended December 31, 2005, we received \$33.3 million from the federal universal service fund and \$20.6 million from the Texas universal service fund. In the aggregate, these payments comprised 16.8% of revenues for the year ended December 31, 2005. In 2006 our subsidies included a net refund of \$1.3 million from us back to the universal service funds for prior periods, and in 2005 our subsidies included a net recovery of \$1.7 million in subsidy payments from the universal service funds to us for prior periods.

Experienced Management Team with Proven Track Record

With an average of over 20 years of experience in both regulated and non-regulated telecommunications businesses, our management team has demonstrated the ability to deliver profitable growth while providing high levels of customer satisfaction. Specifically, our management team has:

- particular expertise in providing superior quality services to rural customers in a regulated environment;

- a proven track record of successful business integrations and acquisitions, including the integration of ICTC and several related businesses into McLeodUSA in 1997, the acquisition of ICTC in 2002 and the TXUCV acquisition and related integration in 2004 and 2005; and

- a proven track record of launching and growing of new services, such as DSL and IPTV, along with complementary services, such as operator, telemarketing and order fulfillment services and directory publishing.

Business Strategy

Increase Revenues Per Customer

We continue to focus on increasing our revenues per customer, primarily by improving our DSL and IPTV market penetration, increasing the sale of other value-added services and encouraging customers to take advantage of our service bundles. We believe that our strategy enables us to provide a more complete package of services to our customers and increase our ARPU, while improving the value for the customer.

Over the last two years we have expanded our service bundle with the introduction of IPTV in selected Illinois and Texas markets. Having made the necessary upgrades to our network and purchased programming content, we introduced IPTV in 2005 in Illinois and began a controlled launch in Texas in August 2006. The product is currently available in our Conroe and Katy markets in Texas. We have been marketing our “triple play” bundle, which includes local voice, DSL and IPTV services. As of December 31, 2006, over 90% of the customers that have subscribed to our video service have taken our triple play offering. In total, we had 6,954 video subscribers and passed approximately 90,000 homes at year-end 2006.

Improve Operating Efficiency

Since acquiring our Illinois operations in December 2002 and our Texas operations in April 2004, we have made significant operating and management improvements. We have centralized many of our business and back office operations into one functional organization with common work groups, processes and systems. By providing these centrally managed resources, we have allowed our management and customer service functions to focus on the business and to better serve our customers in a cost-effective manner.

Maintain Capital Expenditure Discipline

We have successfully managed our capital expenditures in order to optimize our returns, while allocating resources to maintain and upgrade our network and enable new service delivery. This was demonstrated by the completion of the IP network in both states and the subsequent rollout of IPTV service. By upgrading the network to an IP based architecture we were able to provide not only a more efficient network, but one that is capable of offering new services such as IPTV.

Pursue Selective Acquisitions

We intend to pursue a disciplined process of selective acquisitions of access lines or operating companies. Our acquisition criteria include:

- attractiveness of the markets;
- quality of the network;
- our ability to integrate the acquired company efficiently;
- potential operating synergies; and
- cash flow accretive from day one.

Source of Revenues

The following chart summarizes our primary sources of revenues for the last two years:

	Year Ended December 31,			
	2006		2005	
	<u>\$ (millions)</u>	<u>% of Total Revenues</u>	<u>\$ (millions)</u>	<u>% of Total Revenues</u>
Revenues				
Telephone Operations				
Local calling services	\$ 85.1	26.6%	\$ 88.2	27.4%
Network access services	68.1	21.2	64.4	20.0
Subsidies	47.6	14.8	53.9	16.8
Long distance services	15.2	4.7	16.3	5.1
Data and internet services	30.9	9.6	25.8	8.0
Other services	33.5	10.5	33.7	10.5
Total Telephone Operations	280.4	87.4	282.3	87.8
Other Operations	40.4	12.6	39.1	12.2
Total operating revenues	<u>\$ 320.8</u>	<u>100.0</u>	<u>\$ 321.4</u>	<u>100.0</u>

Telephone Operations

Our Telephone Operations segment consists of local calling services, network access services, subsidies, long distance services, data and internet services, and other services. As of December 31, 2006, our Telephone Operations segment had approximately:

- 233,689 local access lines in service, of which approximately 66% served residential customers and 34% served business customers;
- 148,181 total long distance lines, including 130,741 lines from within our service areas, which represented 56.0% penetration of our local access lines;
- 52,732 DSL lines, which represented approximately 35.0% penetration of our primary residential access lines. Approximately 92% of our total local access lines are DSL-capable;
- 6,954 IPTV subscribers; and
- 11,942 dial-up Internet customers

Our Telephone Operations segment generated approximately \$82.9 million and \$76.9 million of cash flows from operating activities for the years ended December 31, 2006 and 2005, respectively. As of December 31, 2006, our Telephone Operations had total assets of approximately \$865.2 million.

Local calling services include dial tone and local calling services. We generally charge residential and business customers a fixed monthly rate for access to the network and for originating and receiving telephone calls within their local calling area. Custom calling features consist of caller name and number identification, call forwarding and call waiting. Value added services consist of teleconferencing and voicemail. For custom calling features and value added services, we usually charge a flat monthly fee, which varies depending on the type of service. In addition, we offer local private lines providing direct connections between two or more local locations primarily to business customers at flat monthly rates. In our Texas markets we offer small businesses a hosted VOIP solution that delivers local, long distance, calling features, internet handsets and unified messaging all in an attractive bundle.

Network access services allow the origination or termination of calls in our service area for which we charge long distance or other carriers network access charges, which are regulated. Network access fees also apply to private lines provisioned between a customer in our service areas and a location outside of our service areas. Included in this category are subscriber line charges, local number portability and universal services surcharges paid by the end user.

We record the details of the long distance and private line calls through our carrier access billing system and bill the applicable carrier on a monthly basis. The network access charge rates for intrastate long distance calls and private lines within Illinois and Texas are regulated and approved by the Illinois Commerce Commission, or ICC, and the Public Utility Commission of Texas, or PUCT, respectively, whereas the access charge rates for interstate long distance calls and private lines are regulated and approved by the Federal Communications Commission, or FCC.

Subsidies consist of federal and state subsidies designed to promote widely available, quality telephone service at affordable prices in rural areas. The subsidies are allocated and distributed to us from funds to which telecommunications providers, including local, long distance and wireless carriers, must contribute on a monthly basis. Funds are distributed to us on a monthly basis based upon our costs for providing local service in our two service territories. In Illinois we receive federal but not state subsidies, while in Texas we receive both federal and state subsidies.

Long distance services include services provided to subscribers to our long distance plans to originate calls that terminate outside the caller's local calling area. We offer a variety of plans and charge our subscribers a combination of subscription and usage fees.

Data and Internet services include revenues from non-local private lines and the provision of access to the Internet by DSL, T-1 lines and dial-up access and IPTV. We also offer a variety of data connectivity services, including Asynchronous Transfer Mode and gigabit Ethernet products and frame relay networks. Frame relay networks are public data networks commonly used for local area network to local area network communications as an alternative to private line data communications. In addition, we launched IPTV in selected Illinois markets in 2005 and selected Texas markets in August 2006.

Other Services within our Telephone Operations segment include revenues from telephone directory publishing, wholesale transport services on a fiber optic network in Texas, billing and collection services, inside wiring service and maintenance. It also includes our limited partnership interests in the following two cellular partnerships:

- GTE Mobilnet of South Texas, which serves the greater Houston metropolitan area. We own approximately 2.3% of this partnership. Because of our minor ownership interest and our inability to influence the operations of this partnership, we account for this investment using the cost basis. As a result, income is recognized only on cash distributions paid to us up to our proportionate earnings in the partnership. We recognized income on cash distributions of \$4.0 million and \$0.8 million from this partnership for the years ended December 31, 2006 and 2005, respectively.
- GTE Mobilnet of Texas RSA #17, which serves areas in and around Conroe, Texas. We own approximately 17.0% of the equity of this partnership. Because of our ownership interest in this partnership, we account for this investment under the equity method. As a result, we recognize income based on the proportion of the earnings generated by the partnership that would be allocated to us. Cash distributions are recorded as a reduction in our investment amount. For the year ended December 31, 2006, we recognized income of \$2.8 million and received cash distributions of \$1.0 million from this partnership. In 2005, we recognized income of \$1.8 million and received cash distributions of \$0.3 million from this partnership.

San Antonio MTA, L.P., a wholly owned partnership of Cellco Partnership (doing business as Verizon Wireless), is the general partner for both partnerships.

Other Operations

Our Other Operations segment consists of complementary businesses including Public Services, Business Systems, Market Response, Operator Services and Mobile Services. Public Services provides local and long distance service and automated calling service for correctional facilities. Business Systems sells and installs telecommunications equipment, such as key and private branch exchange telephone systems to residential and business customers. Market Response provides telemarketing and order fulfillment services. Operator Services offers both live and automated local and long distance operator services and national directory assistance on a wholesale and retail basis. Mobile Services provides one-way messaging service to residential and business customers and includes revenues from our Illinois cellular agency operations.

Our Other Operations segment generated approximately \$1.7 million and \$2.4 million of cash flows from operating activities for the years ended December 31, 2006 and 2005, respectively. As of December 31, 2006, our Other Operations had total assets of approximately \$24.4 million.

Customers and Markets

Our Illinois local telephone markets consist of 35 geographically contiguous exchanges serving predominantly small towns and rural areas in an approximately 2,681 square mile area primarily in five central Illinois counties: Coles; Christian; Montgomery; Effingham; and Shelby. An exchange is a geographic area established for administration and pricing of telecommunications services. We are the incumbent provider of basic telephone services within these exchanges, with approximately 79,014 local access lines, or approximately 29 lines per square mile, as of December 31, 2006. Approximately 62% of our local access lines serve residential customers and the remainder serve business customers. Our business customers are predominantly small retail, commercial, light manufacturing and service industry accounts, as well as universities and hospitals.

Our 21 exchanges in Texas serve three principal geographic markets: Lufkin, Conroe, and Katy, Texas in an approximately 2,054 square mile area. Lufkin is located in east Texas and Conroe and Katy are located in the suburbs of Houston and adjacent rural areas. We are the incumbent provider of basic telephone services within these exchanges, with approximately 154,675 local access lines, or approximately 75 lines per square mile, as of December 31, 2006. Approximately 69% of our Texas local access lines served residential customers and the remainder served business customers. Our Texas business customers are predominately manufacturing and retail industries accounts, and our largest business customers are hospitals, local governments and school districts.

The Lufkin market is centered primarily in Angelina County in east Texas, approximately 120 miles northeast of Houston and extends into three neighboring counties. Lufkin is the largest town within this market, which also includes the towns of Diboll, Hudson and Huntington. The area is a center for the lumber industry and includes other significant industries such as education, health care, manufacturing, retail and social services.

The Conroe market is located primarily in Montgomery County and is centered approximately 40 miles north of Houston on Interstate I-45. Parts of the Conroe operating territory extend south to within 28 miles of downtown Houston, including parts of the affluent suburb of The Woodlands. Major industries in this market include education, health care, manufacturing, retail and social services.

The Katy market is located in parts of Fort Bend, Harris, Waller and Brazoria counties and is centered approximately 30 miles west of downtown Houston along the busy and expanding I-10 corridor. The majority of the Katy market is considered part of metropolitan Houston with major industries including administrative, education, health care, management, professional, retail, scientific and waste management services.

Sales and Marketing

Telephone Operations

The key components of our overall marketing strategy in our Telephone Operations segment include the following:

- positioning ourselves as a single point of contact for our customers' telecommunications needs;
- providing our customers with a broad array of voice and data services and bundling services where possible;
- providing excellent customer service, including providing 24-hour, 7-day a week centralized customer support to coordinate installation of new services, repair and maintenance functions;
- developing and delivering new services; and
- leveraging our history and involvement with local communities and expanding "Consolidated Communications" and "Consolidated" brand recognition.

Our sales strategy is focused on increasing DSL and IPTV service penetration in all of our service areas, cross-selling our services, developing additional services to maximize revenues and increase ARPU, and increasing customer loyalty through superior customer service, local presence and motivated service employees.

Our Telephone Operations segment currently has three sales channels: call centers, communication centers and commissioned sales people. Our customer service call centers serve as the primary sales channels for residential and business customers with one or two phone lines, whereas commissioned sales representatives provide customized proposals to larger business customers. In 2006, we formed a new team of commissioned sales people, our "Feet on the Street" team. This team canvasses our territory offering residential customers our full suite of products, leading with our triple-play bundled offering of voice, DSL and IPTV services. Beyond the strong

sales point of contact, this sales channel also helps us to identify and address customer service issues, if any, on a proactive face to face basis. Our customers can also visit one of our eight communications centers for their various communications needs, including new telephone, Internet service and IPTV purchases. We believe that communication centers have helped decrease our customers' late payments and bad debt due to their ability to pay their bills easily at these centers. Our Telephone Operations' sales efforts are supported by direct mail, bill inserts, newspaper advertising, public relations activities, sponsorship of community events and website promotions.

Directory Publishing is supported by a dedicated sales force, which spends a certain number of months each year focused on each of the directory markets in order to maximize the advertising sales in each directory. We believe the directory business has been an efficient tool for marketing our other services and for promoting brand development and awareness.

Transport Services has a sales force that consists of commissioned sales people specializing in wholesale transport products.

Other Operations

Each of our Other Operations businesses primarily uses an independent sales and marketing team comprised of dedicated field sales account managers, management teams and service representatives to execute our sales and marketing strategy. These efforts are supported by attendance at industry trade shows and leadership in industry groups including the United States Telecom Association, the Associated Communications Companies of America and the Independent Telephone and Telecommunications Alliance.

Information Technology and Support Systems

Our information technology and support systems staff is a seasoned organization that supports day-to-day operations and develops system enhancements. The technology supporting our Telephone Operations segment is centered on a core of commercially available and internally maintained systems.

Over the past two years we successfully migrated most of the key business processes of our Illinois and Texas telephone operations onto single, company-wide systems and platforms including common network provisioning, network management, workforce management systems and financial systems. Our final project, Phase Three of billing integration, is scheduled to be completed during the second half of 2007. Phase Three involves the upgrade of our telephone billing system in Illinois to our latest version of our core billing software utilized by the rest of telephone operations. Our core operating systems and hardware platform provide for significant scalability.

Network Architecture and Technology

Our local networks are based on a carrier serving area architecture. Carrier serving area architecture is a structure that allows access equipment to be placed closer to customer premises enabling the customer to be connected to the equipment over shorter copper loops than would be possible if all customers were connected directly to the carrier's main switch. The access equipment is then connected back to that switch on a high capacity fiber circuit, resulting in extensive fiber deployment throughout the network. The access equipment is sometimes referred to as a digital loop carrier and the geographic area that it serves is the carrier serving area.

A single engineering team is responsible for the overall architecture and interoperability of the various elements in the combined network of our Illinois and Texas telephone operations. Our network operations center, or NOC, in Lufkin, TX, monitors the performance of our communications network at a system level, 24 hours per day, 365 days per year. This center is connected to our customer facing NOC in Mattoon, Illinois which deals with customer specific issues and together they function as one organization. We believe these NOCs allow our Illinois and Texas Telephone Operations to maintain high network performance standards, using common network systems and platforms, which allows us to efficiently handle weekend and after-hours coverage between markets and more efficiently allocate personnel to manage fluctuations in our workload volumes.

Our network is supported by advanced 100% digital switches, with a fiber network connecting 54 of our 56 exchanges. These switches provide all of our local telephone customers with access to custom calling features, value-added services and dial-up Internet access. We have four additional switches: one which supports feature rich Voice Over Internet Protocol known as VOIP, two dedicated to long distance service and one which supports our Public Services and Operator Services businesses. In addition, approximately 92% of our total local access lines are served by exchanges or carriers equipped with digital subscriber line access multiplexers, or DSLAMs, and are within distance limitations for providing DSL service. DSLAMs are devices designed to separate voice-frequency signals from DSL traffic.

We commenced the network improvements needed to support the introduction of our IPTV service, which is functionally similar to a digital cable television offering in our Illinois markets in 2003 and in our Texas markets in 2005. We have since completed the initial capital investments including associated IP backbone projects and developed the content relationships necessary to provide these services and introduced IPTV in selected Illinois markets in 2005 and selected Texas markets in August 2006. Other than the provision of success-based set-top boxes to subscribers, we do not anticipate having to make any material capital upgrades to our network infrastructure in connection with our expansion of IPTV in these markets. As of December 31, 2006, IPTV was available to approximately 90,000 homes in our markets. Our IPTV subscriber base has grown from 2,146 as of December 31, 2005 to 6,954 as of December 31, 2006.

In Texas we operate a transport network which consists of approximately 2,500 route-miles of fiber optic cable. Approximately 54% of this network consists of cable sheath owned by us, either directly or through our majority-owned subsidiary East Texas Fiber Line Incorporated and a partnership partly owned by us, Fort Bend Fibernet. For most of the remaining route-miles of the network, we purchased strands on third-party fiber networks pursuant to contracts commonly known as indefeasible rights of use. In limited cases, we also lease capacity on third-party fiber networks to complete routes, in addition to these fiber routes. These assets also support our IPTV video product in Texas as well as our Texas transport services business.

Employees

As of December 31, 2006, we had a total of 1,123 employees, of which 1,021 were full-time and 102 were part-time. Approximately 374 of the employees located in Illinois are represented by the International Brotherhood of Electrical Workers under a collective bargaining agreement that was renewed on November 15, 2005 for a period of three years. Approximately 188 of the employees located in Texas are represented by the Communications Workers of America under a collective bargaining agreement that was renewed on November 4, 2004 for a period of three years. We believe that management currently has a good relationship with our employees.

Competition

Local Telephone Market

In general, telecommunications service in rural areas is more costly to provide than service in urban areas because the lower customer density necessitates higher capital expenditures on a per customer basis. As a result, it is generally not economically viable for competitors to overbuild in rural territories. Despite the barriers to entry for voice services, rural telephone companies face some competition for voice services from new market entrants, such as cable providers, wireless providers and competitive telephone companies. Cable providers are entering the telecommunications market by upgrading their networks with fiber optics and installing facilities to provide fully interactive transmission of broadband voice, data and video communications. Competitive telephone companies are competitors that have been granted permission by a state regulatory commission to offer local telephone service in an area already served by a local telephone company. Electric utility companies have existing assets and low cost access to capital that may allow them to enter a market rapidly and accelerate network development.

VOIP service is increasingly being embraced by all industry participants. VOIP service essentially involves the routing of voice calls, at least in part, over the Internet through packets of data instead of transmitting the calls over the existing telephone system. While current VOIP applications typically complete calls using incumbent telephone company infrastructure and networks, as VOIP services obtain acceptance and market penetration and technology advances further, a greater quantity of communication may be placed without the use of the telephone system. On March 10, 2004, the FCC issued a Notice of Proposed Rulemaking with respect to IP-enabled Services. Among other things, the FCC is considering whether VOIP Services are regulated telecommunications services or unregulated information services. We cannot predict the outcome of the FCC's rulemaking or the impact on the revenues of our rural telephone companies. The proliferation of VOIP, particularly to the extent such communications do not utilize our rural telephone companies' networks, may result in an erosion of our customer base and loss of access fees and other funding.

Currently Mediacom, which serves the eastern portion of our Illinois service territory, is providing competition for basic voice services with its VOIP offering. We estimate that Mediacom overlaps approximately 15% of our total access lines. The major cable television supplier in the western portion of our Illinois territory is Charter Communications. Our Texas properties face video and DSL competition from Comcast and Suddenlink. While Mediacom is the only cable provider offering a competitive voice offering in our service area, we are preparing for the launch of voice products by the other cable providers in our service area.

Wireless Service

Rural telephone companies face competition for voice services from wireless carriers. However, rural telephone companies usually face less wireless competition than non-rural providers of voice services because wireless networks in rural areas are generally less developed than in urban areas. Our service areas in Conroe and Katy, Texas are exceptions to this general rule due to their proximity to Houston and, as a result, are facing increased competition from wireless service providers. Although we do not believe that wireless technology represents a significant threat to our rural telephone companies in the near term, we expect to face increased competition from wireless carriers as technology, wireless network capacity and economies of scale improve, wireless service prices continue to decline and subscribers continue to increase.

Internet Service

The Internet services market in which we operate is highly competitive and there are few barriers to entry. Industry sources expect competition to intensify. Internet services, meaning both Internet access, wired and wireless, and on-line content services, are provided by cable providers, Internet service providers, long distance carriers and satellite-based companies. Many of these companies provide direct access to the Internet and a variety of supporting services to businesses and individuals. In addition, many of these companies offer on-line content services consisting of access to closed, proprietary information networks. Cable providers and long distance carriers, among others, are aggressively entering the Internet access markets. Both have substantial transmission capabilities, traditionally carry data to large numbers of customers and have a billing system infrastructure that permits them to add new services. Satellite companies are also offering broadband access to the Internet. We expect that competition for Internet services will increase.

Long Distance Service

The long distance telecommunications market is highly competitive. Competition in the long distance business is based primarily on price, although service bundling, branding, customer service, billing service and quality play a role in customers' choices.

Other Competition

Our other lines of business are subject to substantial competition from local, regional and national competitors. In particular, our directory publishing and transport businesses operate in competitive markets. We expect that competition as a general matter in our businesses will continue to intensify as new technologies and new services are offered. Our businesses operate in a competitive environment where long-term contracts are either not the norm or have cancellation clauses that allow quick termination of the agreements. Where long-term contracts are common, they are being renewed with shorter duration terms. Customers in these businesses can and do change vendors frequently. Customer business failures and consolidation of customers through mergers and buyouts can cause loss of customers.

Regulatory Environment

The following summary does not describe all present and proposed federal, state and local legislation and regulations affecting the telecommunications industry. Some legislation and regulations are currently the subject of judicial proceedings, legislative hearings and administrative proposals that could change the manner in which this industry operates. Neither the outcome of any of these developments, nor their potential impact on us, can be predicted at this time. Regulation can change rapidly in the telecommunications industry, and these changes may have an adverse effect on us in the future. See "Risk Factors -- Regulatory Risks".

Overview

The telecommunications industry in which we operate is subject to extensive federal, state and local regulation. Pursuant to the Telecommunications Act, federal and state regulators share responsibility for implementing and enforcing statutes and regulations designed to encourage competition and the preservation and advancement of widely available, quality telephone service at affordable prices. At the federal level, the Federal Communications Commission, or FCC, generally exercises jurisdiction over facilities and services of local exchange carriers, such as our rural telephone companies, to the extent they are used to provide, originate or terminate interstate or international communications. State regulatory commissions, such as the ICC and the PUCT, generally exercise jurisdiction over these facilities and services to the extent they are used to provide, originate or terminate intrastate communications. In particular, state regulatory agencies have substantial oversight over interconnection and network access by competitors of our rural telephone companies. In addition, municipalities and other local government agencies regulate the public rights-of-way necessary to install and operate networks.

The FCC has the authority to condition, modify, cancel, terminate or revoke our operating authority for failure to comply with applicable federal laws or rules, regulations and policies of the FCC. Fines or other penalties also may be imposed for any of these violations. In addition, the states have the authority to sanction our rural telephone companies or to revoke our certifications if we violate relevant laws or regulations.

Federal Regulation

Our rural telephone companies must comply with the Communications Act of 1934, as amended, or the Communications Act, which requires, among other things, that telecommunications carriers offer services at just and reasonable rates and on non-discriminatory terms and conditions. The amendments to the Communications Act enacted in 1996 and contained in the Telecommunications Act dramatically changed, and are expected to continue to change, the landscape of the telecommunications industry.

Access Charges

A significant portion of our rural telephone companies' revenues come from network access charges paid by long distance and other carriers for originating or terminating calls within our rural telephone companies' service areas. The amount of network access charge revenues our rural telephone companies receive is based on rates set by federal and state regulatory commissions, and these rates are subject to change at any time. The FCC regulates the prices our rural telephone companies may charge for the use of our local telephone facilities in originating or terminating interstate and international transmissions. The FCC has structured these prices as a combination of flat monthly charges paid by the end-users and usage sensitive charges or flat monthly rate charges paid by long distance or other carriers. Intrastate network access charges are regulated by state commissions, which in our case are the ICC and the PUCT. Our Illinois rural telephone company's intrastate network access charges currently mirror interstate network access charges for all but one element, local switching. In contrast, in accordance with the regulatory regime in Texas, our Texas rural telephone companies currently charge significantly higher intrastate network access charges than interstate network access charges.

The FCC regulates levels of interstate network access charges by imposing price caps on Regional Bell Operating Companies, referred to as RBOC's, and large incumbent telephone companies. These price caps can be adjusted based on various formulae, such as inflation and productivity, and otherwise through regulatory proceedings. Small incumbent telephone companies may elect to base network access charges on price caps, but are not required to do so. Our Illinois rural telephone company and Texas rural telephone companies elected not to apply federal price caps. Instead, our rural telephone companies employ rate-of-return regulation for their network interstate access charges, whereby they earn a fixed return on their investment over and above operating costs. The FCC determines the profits our rural telephone companies can earn by setting the rate-of-return on their allowable investment base, which is currently 11.25%.

Traditionally, regulators have allowed network access rates to be set higher in rural areas than the actual cost of terminating or originating long distance calls as an implicit means of subsidizing the high cost of providing local service in rural areas. Following a series of federal circuit court decisions in 2001 ruling that subsidies must be explicit rather than implicit, the FCC began to consider various reforms to the existing rate structure for interstate network access rates as proposed by the Multi Association Group and the Rural Task Force, each of which is a consortium of various telecommunications industry groups. We believe that the states will likely mirror any FCC reforms in establishing intrastate network access charges.

In 2001, the FCC adopted an order implementing the beginning phases of the plan of the Multi Association Group to reform the network access charge system for rural carriers. The FCC reforms reduced network access charges and shifted a portion of cost recovery, which historically was based on minutes of use and was imposed on long distance carriers, to flat-rate, monthly subscriber line charges imposed on end-user customers. While the FCC has simultaneously increased explicit subsidies through the universal service fund to rural telephone companies, the aggregate amount of interstate network access charges paid by long distance carriers to access providers, such as our rural telephone companies, has decreased and may continue to decrease.

The FCC's 2001 access reform order had a negative impact on the intrastate network access revenues of our Illinois rural telephone company. Under Illinois network access regulations, our Illinois rural telephone company's intrastate network access rates mirror interstate network access rates. Illinois, however, unlike the federal system, does not provide an explicit subsidy in the form of a universal service fund. Therefore, while subsidies from the federal universal service fund offset Illinois Telephone Operations' decrease in revenues resulting from the reduction in interstate network access rates, there was not a corresponding offset for the decrease in revenues from the reduction in intrastate network access rates. In Texas, because the intrastate network access rate regime applicable to our Texas rural telephone companies does not mirror the FCC regime, the impact of the reforms was revenue neutral. The PUCT is continuing to investigate possible changes to the structure for intrastate access charges and the Texas legislature is expected to consider potential changes to rates during the legislative session beginning in January, 2007.

In recent years, long distance carriers and other such carriers have become more aggressive in disputing interstate access charge rates set by the FCC and the applicability of access charges to their telecommunications traffic. We believe that these disputes have increased in part due to advances in technology which have rendered the identity and jurisdiction of traffic more difficult to ascertain and which have afforded carriers an increased opportunity to assert regulatory distinctions and claims to lower access costs for their traffic. For example in September 2003, Vonage Holdings Corporation filed a petition with the FCC to preempt an order of the Minnesota Public Utilities Commission which had issued an order requiring Vonage to comply with the Minnesota Commission's order. The FCC determined that Vonage's VOIP service was such that it was impossible to divide it into interstate and intrastate components without negating federal rules and policies. Accordingly, the FCC found it was an interstate service not subject to traditional state telephone regulation. While the FCC order did not specifically address the issue of the application of intrastate access charges to Vonage's VOIP service, the fact that the service was found to be solely interstate raises that concern. We cannot predict what other actions that other long distance carriers may take before the FCC or with their local exchange carriers, including our rural telephone companies, to challenge the applicability of access charges. To date, no long distance or other carrier has made a claim to us contesting the applicability of network access charges billed by our rural telephone companies. We cannot assure you, however, that long distance or other carriers will not make such claims to us in the future nor, if such a claim is made, can we predict the magnitude of the claim. As a result of the increasing deployment of VOIP services and other technological changes, we believe that these types of disputes and claims will likely increase.

On July 25, 2006 the FCC issued for comment CC Docket 01-92, Missoula Inter-carrier Compensation Plan, or the Missoula Plan. Consolidated is a signed supporter of the Missoula Plan. Both the ICC and the PUCT have filed comments in opposition to the Missoula Plan. We continue to actively participate in shaping inter-carrier compensation and universal service reforms through our own efforts as well as through industry associations and coalitions.

Removal of Entry Barriers

The central aim of the Telecommunications Act of 1996 is to open local telecommunications markets to competition while enhancing universal service. Prior to the enactment of the Telecommunications Act, many states limited the services that could be offered by a company competing with an incumbent telephone company. The Telecommunications Act preempts these state and local laws.

The Telecommunications Act imposes a number of interconnection and other requirements on all local communications providers. All telecommunications carriers have a duty to interconnect directly or indirectly with the facilities and equipment of other telecommunications carriers. Local exchange carriers, including our rural telephone companies, are required to:

- allow others to resell their services;
- where feasible, provide number portability;
- ensure dialing parity, whereby consumers can choose their local or long distance telephone company over which their calls will automatically route without having to dial additional digits;
- ensure that competitors' customers receive nondiscriminatory access to telephone numbers, operator service, directory assistance and directory listing;
- afford competitors access to telephone poles, ducts, conduits and rights-of-way;
- and establish reciprocal compensation arrangements for the transport and termination of telecommunications traffic.

Furthermore, the Telecommunications Act imposes on incumbent telephone companies, other than rural telephone companies that maintain their so-called "rural exemption", additional obligations, by requiring them to:

- negotiate any interconnection agreements in good faith;
- interconnect their facilities and equipment with any requesting telecommunications carrier, at any technically feasible point, at nondiscriminatory rates and on nondiscriminatory terms and conditions;
- provide nondiscriminatory access to unbundled network elements, commonly known as UNEs, such as local loops and transport facilities, at any technically feasible point, at nondiscriminatory rates and on nondiscriminatory terms and conditions;
- offer their retail services for resale at discounted wholesale rates;
- provide reasonable notice of changes in the information necessary for transmission and routing of services over the incumbent telephone company's facilities or in the information necessary for interoperability;
- and provide, at rates, terms and conditions that are just, reasonable and nondiscriminatory, for the physical co-location of equipment necessary for interconnection or access to UNEs at the premises of the incumbent telephone company.

The unbundling requirements have been some of the most controversial requirements of the Telecommunications Act. The FCC, in its initial implementation of the law, had generally required incumbent telephone companies to lease a wide range of unbundled network elements to competitive telephone companies to enable delivery of services to the competitor's customers in combination with the competitive telephone companies' network or as a recombined service offering on an unbundled network element platform, commonly known as an UNEP. These unbundling requirements, and the duty to offer UNEs to competitors, imposed substantial costs on, and resulted in customer attrition for, the incumbent telephone companies that had to comply with these requirements. In response to a decision by the U.S. Court of Appeals for the D.C. Circuit vacating portions of its UNE and UNEP rules, the FCC issued revised rules on February 4, 2005 that reinstated some unbundling requirements for incumbent telephone companies that are not protected by the rural exemption but eliminated certain other unbundling requirements. In particular, incumbent telephone companies are no longer required to offer the UNEP, although they are still required to offer loop and transport UNEs in most markets.

Rural Exemption

Each of the subsidiaries through which we operate our local telephone businesses is an incumbent telephone company and provides service in rural areas. The Telecommunications Act exempts rural telephone companies from certain of the more burdensome interconnection requirements such as unbundling of network elements, information sharing and co-location. On March 31, 2006, Sprint filed a petition with the PUCT to lift the rural exemption for both of the Texas rural telephone companies and on July 25, 2006, the PUCT has ordered the rural exemption be lifted for both companies. The PUCT's decision has been appealed to the United States District Court on the grounds that Sprint did not properly make a request for interconnection or revocation of our rural exemptions and a ruling is expected in mid 2007.

Promotion of Universal Service

In general, telecommunications service in rural areas is more costly to provide than service in urban areas because there is a lower customer density and higher capital requirements compared to urban areas. The low customer density in rural areas means that switching and other facilities serve fewer customers and loops are typically longer requiring greater capital expenditure per customer to build and maintain. By supporting the high cost of operations in our rural markets, the federal universal service fund subsidies our rural telephone companies receive are intended to promote widely available, quality telephone service at affordable prices in rural areas. In 2006 and 2005 we received \$47.6 million and \$53.9 million, respectively, in aggregate payments from the federal universal service fund and the Texas universal service fund.

The administration of collections and distributions of federal universal service fund payments is performed by the National Exchange Carrier Association, or NECA, which was formed by the FCC in 1983 to perform telephone industry tariff filings and revenue distributions following the breakup of AT&T. The board of directors of NECA is comprised of representatives from the RBOCs, large and small incumbent telephone companies and other industry participants. NECA also performs various other functions including filing access charge tariffs with the FCC, collecting and validating cost and revenues data, assisting with compliance with FCC rules and processing FCC regulatory fees.

NECA distributes federal universal service fund subsidies only to carriers that are designated as eligible telecommunications carriers, or ETCs, by a state commission. Each of our rural telephone companies has been designated as an ETC by the applicable state commission. Under the Telecommunications Act, however, competitors can obtain the same level of federal universal service fund subsidies as we do, per line served, if the ICC or PUCT, as applicable, determines that granting such federal universal service fund subsidies to competitors would be in the public interest and the competitors offer and advertise certain telephone services as required by the Telecommunications Act and the FCC. The ICC has granted several petitions for ETC designations. We are not aware of any having been filed in our Texas service areas. Under current rules, the subsidies received by our rural telephone companies are not affected by any such payments to competitors.

With some limitations, incumbent telephone companies receive federal universal service fund subsidies pursuant to existing mechanisms for determining the amounts of such payments on a cost per loop basis. The FCC has adopted, with modifications, the proposed framework of the Rural Task Force for rural, high-cost universal service fund subsidies. The FCC order modifies the existing universal service fund mechanism for rural telephone companies and adopts an interim embedded, or historical, cost mechanism for a five-year period that provides predictable levels of support to rural carriers. The FCC intends to develop a long-term plan based on forward-looking costs when the five-year period expires in 2006.

The FCC has made modifications to the universal service support system that changed the sources of support and the method for determining the level of support. These changes, which, among other things, removed the implicit support from network access charges and made it explicit support, have been, generally, revenue neutral to our rural telephone companies' operations. It is unclear whether the changes in methodology will continue to accurately reflect the costs incurred by our rural telephone companies and whether it will provide for the same amount of universal service support that our rural telephone companies have received in the past. In addition, several parties have raised objections to the size of the federal universal service fund and the types of services eligible for support. A number of issues regarding the source and amount of contributions to, and eligibility for payments from, the federal universal service fund need to be resolved in the near future. The FCC recently adopted new rules making it more difficult for competitors to qualify for federal universal service subsidies.

In December 2005, Congress suspended the application of a law called the Anti Deficiency Act to the FCC's universal service fund until December 31, 2006. The Anti Deficiency Act prohibits government agencies from making financial commitments in excess of their funds on hand. Currently, the universal service fund administrator makes commitments to fund recipients in advance of collecting the contributions from carriers that will pay for these commitments. The FCC has not determined whether the Anti Deficiency Act would apply to payments to our rural telephone companies. Congress is now considering whether to extend the current temporary legislation that exempts the universal service fund from the Anti Deficiency Act. If it does not grant this extension, however, the universal service subsidy payments to our rural telephone companies may be delayed or reduced in the future.

We cannot predict the outcome of any FCC rulemaking or similar proceedings. The outcome of any of these proceedings or other legislative or regulatory changes could affect the amount of universal service support received by our rural telephone companies.

State Regulation of CCI Illinois

Illinois requires providers of telecommunications services to obtain authority from the ICC prior to offering common carrier services. Our Illinois rural telephone company is certified to provide local telephone services. In addition, Illinois Telephone Operations' long distance, operator services and payphone services subsidiaries hold the necessary certifications in Illinois and the other states in which they operate. In Illinois, our long distance, operator services and payphone services subsidiaries are required to file tariffs with the ICC but generally can change the prices, terms and conditions stated in their tariffs on one day's notice, with prior notice of price increases to affected customers. Our Illinois Telephone Operations other services are not subject to any significant state regulations in Illinois. Our Other Illinois Operations are not subject to any significant state regulation outside of any specific contractually imposed obligations.

Our Illinois rural telephone company operates as a distinct company from an Illinois regulatory standpoint and is regulated under a rate of return system for intrastate revenues. Although the FCC has preempted certain state regulations pursuant to the Telecommunications Act, as explained above, Illinois retains the authority to impose requirements on our Illinois rural telephone company to preserve universal service, protect public safety and welfare, ensure quality of service and protect consumers. For instance, our Illinois rural telephone company must file tariffs setting forth the terms, conditions and prices for their intrastate services and these tariffs may be challenged by third parties. Our Illinois rural telephone company has not had, however, a general rate proceeding before the ICC since 1983.

The ICC has broad authority to impose service quality and service offering requirements on our Illinois rural telephone company, including credit and collection policies and practices, and to require our Illinois rural telephone company to take other actions in order to insure that it meets its statutory obligation to provide reliable local exchange service. In particular, we were required to obtain the approval of the ICC to effect the reorganization we implemented in connection with our IPO. As part of the ICC's review of the reorganization we implemented in connection with our IPO, the ICC imposed various conditions as part of its approval of the reorganization, including (1) prohibitions on payment of dividends or other cash transfers from ICTC to us if it fails to meet or exceed agreed benchmarks for a majority of seven service quality metrics and (2) the requirement that our Illinois rural telephone company have access to the higher of \$5.0 million or its currently approved capital expenditure budget for each calendar year through a combination of available cash and amounts available under credit facilities. During 2007 we expect to satisfy each of the applicable Illinois regulatory requirements necessary to permit ICTC to pay dividends to us.

Any requirements or restrictions of this type could limit the amount of cash that is available to be transferred from our Illinois rural telephone company to the Company and could adversely impact our ability to meet our debt service requirements and to pay dividends on our common stock.

The Illinois General Assembly has made major revisions and added significant new provisions to the portions of the Illinois Public Utilities Act governing the regulation and obligations of telecommunications carriers on at least three occasions since 1985. However, the Illinois General Assembly concluded its session in May 2005 and made no changes to the current state telecommunications law except to extend the sunset date from July 1, 2005 to July 1, 2007. The governor has signed this extension into law. As a result, we expect that the Illinois General Assembly will again consider amendments to the telecommunications article of the Illinois Public Utilities Act in 2007.

State Regulation of CCI Texas

Texas requires providers of telecommunications services to obtain authority from the PUCT prior to offering common carrier services. Our Texas rural telephone companies are each certified to provide local telephone services in their respective territories. In addition, our Texas long distance and transport subsidiaries are registered with the PUCT as interexchange carriers. The transport subsidiary also has obtained from the PUCT a service provider certificate of operating authority ("SPCOA") to better assist the transport subsidiary with its operations in municipal areas. Recently, to assist with expanding services offerings, Consolidated Communications Network Services, Inc. also obtained an SPCOA from the PUCT. While our Texas rural telephone company services are extensively regulated by the PUCT, our other services, such as long distance and transport services, are not subject to any significant state regulation.

Our Texas rural telephone companies operate as distinct companies from a Texas regulatory standpoint. Each Texas rural telephone company is separately regulated by the PUCT in order to preserve universal service, protect public safety and welfare, ensure quality of service and protect consumers. Each Texas rural telephone company also must file and maintain tariffs setting forth the terms, conditions and prices for its intrastate services.

Currently, both Texas rural telephone companies have immunity from adjustments to their rates, including their intrastate network access rates, due to their election of incentive regulation under the Texas Public Utilities Regulatory Act, or PURA. In order to qualify for this incentive regulation, our rural telephone companies agreed to fulfill certain infrastructure requirements and, in exchange, they are not subject to challenge by the PUCT regarding their rates, overall revenues, return on invested capital or net income.

There are two different forms of incentive regulation designated by PURA: Chapter 58 and Chapter 59. Generally under either election, the rates, including network access rates, an incumbent telephone company may charge in connection with basic local services cannot be increased from the amount(s) on the date of election without PUCT approval. Even with PUCT approval, increases can only occur in very specific situations. Pricing flexibility under Chapter 59 is extremely limited. In contrast, Chapter 58 allows greater pricing flexibility on non-basic network services, customer specific contracts and new services.

Initially, both Texas rural telephone companies elected incentive regulation under Chapter 59 and fulfilled the applicable infrastructure requirements to maintain their election status. Consolidated Communications of Texas Company made its election on August 17, 1997. Consolidated Communications of Fort Bend Company made its election on May 12, 2000. On March 25, 2003, both Texas rural telephone companies changed their election status from Chapter 59 to Chapter 58. The rate freezes for basic services with respect to the current Chapter 58 elections are due to expire on March 24, 2007. After the rate freeze related to the Chapter 58 elections expires, the Texas telephone companies are allowed, with PUCT approval, additional pricing flexibility for basic services. Furthermore, the Texas telephone companies have taken the necessary steps to ensure the other protections afforded by their Chapter 58 elections continue after the initial rate freeze for basic services expires.

In connection with the 2003 election by each of our Texas rural telephone companies to be governed under an incentive regulation regime, our Texas rural telephone companies were obligated to fulfill certain infrastructure requirements. While our Texas rural telephone companies have met the current infrastructure requirements, the PUCT could impose additional or other restrictions of this type in the future. Any requirements or restrictions of this type could limit the amount of cash that is available to be transferred from our rural telephone companies to Texas Holdings and could adversely impact our ability to meet our debt service requirements and repayment obligations.

In September 2005, the Texas Legislature adopted significant telecommunications legislation. This legislation created, among other provisions, a statewide video franchise for telecommunications carriers, established a framework for deregulation of the retail telecommunications services offered by incumbent local telecommunications carriers, created requirements for incumbent local telecommunications carriers to reduce intrastate access charges upon the deregulation of markets and directed the PUCT to initiate a study of the Texas Universal Service Fund. We expect that the Texas Legislature may further address issues of importance to rural telecommunications carriers in Texas, including the Texas Universal Service Fund, in the 2007 Legislative session which commenced in January, 2007.

Texas Universal Service

The Texas universal service fund was established within PURA and is administered by NECA. The law directs the PUCT to adopt and enforce rules requiring local exchange carriers to contribute to a state universal service fund which assists telecommunications providers in providing basic local telecommunications service at reasonable rates in high cost rural areas. The Texas universal service fund is also used to reimburse telecommunications providers for revenues lost by providing Tel-Assistance and to reimburse carriers for providing lifeline service. The Texas universal service fund is funded by a statewide charge payable by specified telecommunications providers at rates determined by the PUCT. Our Texas rural telephone companies qualify for disbursements from this fund pursuant to criteria established by the PUCT. We received Texas universal service fund subsidies of \$19.5 million, or 6.0% of our revenues in 2006 and \$20.6 million, or 6.4% of our revenues in 2005. Under the new PURA rules the PUCT has reviewed the Texas universal service fund and is in the process of collaborating with the Texas legislature regarding possible reforms to the fund. We are participating in the current process and anticipate the Texas legislature will take some action regarding the Texas universal service fund during the 2007 legislative session. What specific action will be taken is uncertain at this time.

Local Government Authorizations

In Illinois, we historically have been required to obtain franchises from each incorporated municipality in which our Illinois rural telephone company operates. Effective January 1, 2003, an Illinois state statute prescribes the fees that a municipality may impose on our Illinois rural telephone company for the privilege of originating and terminating messages and placing facilities within the municipality. Illinois Telephone Operations may also be required to obtain from municipal authorities permits for street opening and construction, or operating franchises to install and expand fiber optic facilities in specified rural areas and from county authorities in unincorporated areas. These permits or other licenses or agreements typically require the payment of fees.

Poor economic conditions in our service areas in Illinois and Texas could cause us to lose local access lines and revenues.

Substantially all of our customers and operations are located in Illinois and Texas. The customer base for telecommunications services in each of our rural telephone companies' service areas in Illinois and Texas is small and geographically concentrated, particularly for residential customers. Due to our geographical concentration, the successful operation and growth of our business is primarily dependent on economic conditions in our rural telephone companies' service areas. The economies of these areas, in turn, are dependent upon many factors, including:

- demographic trends;
- in Illinois, the strength of the agricultural markets and the light manufacturing and services industries, continued demand from universities and hospitals and the level of government spending; and
- in Texas, the strength of the manufacturing, health care, waste management and retail industries and continued demand from schools and hospitals.

Poor economic conditions and other factors beyond our control in our rural telephone companies' service areas could cause a decline in our local access lines and revenues.

A system failure could cause delays or interruptions of service could cause us to lose customers.

In the past, we have experienced short, localized disruptions in our service due to factors such as cable damage, inclement weather and service failures of our third party service providers. To be successful, we will need to continue to provide our customers reliable service over our network. The principal risks to our network and infrastructure include:

- physical damage to our central offices or local access lines;
- disruptions beyond our control;
- power surges or outages; and
- software defects.

Disruptions may cause interruptions in service or reduced capacity for customers, either of which could cause us to lose customers and incur unexpected expenses, and thereby adversely affect our business, revenue and cash flow.

Loss of a large customer could reduce our revenues. In addition, a significant portion of our revenues from the State of Illinois is based on contracts that are favorable to the government.

Our success depends in part upon the retention of our large customers such as AT&T and the State of Illinois. AT&T accounted for 8.4% and 5.0% and the State of Illinois accounted for 6.0% and 5.8% of our revenues during 2006 and 2005, respectively. In general, telecommunications companies such as ours face the risk of losing customers as a result of contract expiration, merger or acquisition, business failure or the selection of another provider of voice or data services. In addition, we generate a significant portion of our operating revenues from originating and terminating long distance and international telephone calls for the long distance divisions of AT&T and Verizon, which have recently been acquired or experienced substantial financial difficulties. We cannot assure you that we will be able to retain long-term relationships or secure renewals of short-term relationships with our customers in the future.

In 2006 and 2005, 47.0% and 46.2%, respectively, of our Other Operations revenues were derived from our relationships with various agencies of the State of Illinois, principally the Department of Corrections through Public Services. Our relationship with the Department of Corrections accounted for 93.3% and 93.0%, respectively, of our Public Services revenues during 2006 and 2005. Our predecessor's relationship with the Department of Corrections has existed since 1990 despite changes in government administrations. Nevertheless, obtaining contracts from government agencies is challenging, and government contracts, like our contracts with the State of Illinois, often include provisions that are favorable to the government in ways that are not standard in private commercial transactions. Specifically, each of our contracts with the State of Illinois:

- includes provisions that allow the respective state agency to terminate the contract without cause and without penalty under some circumstances;
- is subject to decisions of state agencies that are subject to political influence on renewal;
- gives the State of Illinois the right to renew the contract at its option but does not give us the same right; and
- could be cancelled if state funding becomes unavailable.

The failure of the State of Illinois to perform under the existing agreements for any reason, or to renew the agreements when they expire, could have a material adverse effect on our revenues. For example, the State of Illinois, which represented 40.8% of the revenues of our Market Response business for 2004, awarded the renewal of the Illinois State Toll Highway Authority contract, the sole source of those revenues, to another provider.

If we are unsuccessful in obtaining and maintaining necessary rights-of-way for our network, our operations may be interrupted and we would likely face increased costs.

We need to obtain and maintain the necessary rights-of-way for our network from governmental and quasi-governmental entities and third parties, such as railroads, utilities, state highway authorities, local governments and transit authorities. We may not be successful in obtaining and maintaining these rights-of-way or obtaining them on acceptable terms whether in existing or new service areas. Some of the agreements relating to these rights-of-way may be short-term or revocable at will, and we cannot be certain that we will continue to have access to existing rights-of-way after they have expired or terminated. If any of our rights-of-way agreements were terminated or could not be renewed, we may be forced to remove our network facilities from under the affected rights-of-way or relocate or abandon our networks. We may not be able to maintain all of our existing rights-of-way and permits or obtain and maintain the additional rights-of-way and permits needed to implement our business plan. In addition, our failure to maintain the necessary rights-of-way, franchises, easements, licenses and permits may result in an event of default under the amended and restated credit agreement and other credit agreements we may enter into in the future and, as a result, other agreements governing our debt. As a result of the above, our operations may be interrupted and we may need to find alternative rights-of-way and make unexpected capital expenditures.

We are dependent on third party vendors for our information and billing systems. Any significant disruption in our relationship with these vendors could increase our costs and affect our operating efficiencies.

Sophisticated information and billing systems are vital to our ability to monitor and control costs, bill customers, process customer orders, provide customer service and achieve operating efficiencies. We currently rely on internal systems and third party vendors to provide all of our information and processing systems. Some of our billing, customer service and management information systems have been developed by third parties for us and may not perform as anticipated. In addition, our plans for developing and implementing our information and billing systems rely primarily on the delivery of products and services by third party vendors. Our right to use these systems is dependent upon license agreements with third party vendors. Some of these agreements are cancelable by the vendor, and the cancellation or nonrenewable nature of these agreements could impair our ability to process orders or bill our customers. Since we rely on third party vendors to provide some of these services, any switch in vendors could be costly and affect operating efficiencies.

Share Repurchase

On July 28, 2006, we completed the repurchase of 3,782,379, or 12.7% of the outstanding shares, from Providence Equity for \$56.7 million, or \$15.00 per share. The repurchase was funded with \$17.7 million of cash on hand and \$39.0 million of new borrowings under our existing credit facility.

The effect of the transaction was an annual increase of \$3.0 million of cash flow due to the:

- reduction in our annual dividend obligation of \$5.9 million;
- an increase in our after tax net cash interest of \$2.9 million due to the increased borrowings incurred, an increase in the interest rate on our credit facility of 25 basis points and a decrease of cash on hand.

Factors Affecting Results of Operations**Revenues**

Telephone Operations and Other Operations. To date, our revenues have been derived primarily from the sale of voice and data communications services to residential and business customers in our rural telephone companies' service areas. We do not anticipate significant growth in revenues in our Telephone Operations segment due to its primarily rural service area, but we do expect relatively consistent cash flow from year-to-year due to stable customer demand, limited competition and a generally supportive regulatory environment.

Local Access Lines and Bundled Services. Local access lines are an important element of our business. An "access line" is the telephone line connecting a person's home or business to the public switched telephone network. The monthly recurring revenue we generate from end users, the amount of traffic on our network and related access charges generated from other carriers, the amount of federal and state subsidies we receive and most other revenue streams are directly related to the number of local access lines in service. We had 233,689, 242,024 and 255,208 local access lines in service as of December 31, 2006, 2005 and 2004, respectively.

Many rural telephone companies have experienced a loss of local access lines due to challenging economic conditions, increased competition from wireless providers, competitive local exchange carriers and, in some cases, cable television operators. We have not been immune to these conditions. We also lost local access lines due to the disconnection of second telephone lines by our residential customers in connection with their substituting DSL or cable modem service for dial-up Internet access and wireless service for wireline service. As of December 31, 2006, 2005 and 2004, we had 7,756, 9,144 and 11,115 second lines, respectively. The disconnection of second lines represented 20.2% and 30.1% of our residential line loss in 2006 and 2005, respectively. We expect to continue to experience modest erosion in access lines.

We have mitigated the decline in local access lines with increased average revenue per access line by focusing on the following:

- aggressively promoting DSL service;
- bundling value-adding services, such as DSL or IPTV, with a combination of local service, custom calling features, voicemail and Internet access;
- maintaining excellent customer service standards, particularly as we introduce new services to existing customers; and
- keeping a strong local presence in the communities we serve.

We have implemented a number of initiatives to gain new local access lines and retain existing local access lines by enhancing the attractiveness of the bundle with new service offerings, including unlimited long distance, and promotional offers like discounted second lines. In January 2005 we introduced IPTV in selected Illinois markets. The initial roll-out was initiated in a controlled manner with little advertising or promotion. Upon completion of back-office testing, vendor interoperability between system components and final network preparation, we began aggressively marketing our "triple play" bundle, which includes local service, DSL and IPTV, in our key Illinois exchanges in September 2005. In August 2006 we introduced IPTV service in selected Texas markets. As of December 31, 2006, IPTV was available to approximately 90,000 homes in our markets. Our IPTV subscriber base has grown from 2,146 as of December 31, 2005 to 6,954 as of December 31, 2006. In addition to our access line and video initiatives, we intend to continue to integrate best practices across our Illinois and Texas regions. These efforts may act to mitigate the financial impact of any access line loss we may experience.

Because of our promotional efforts, the number of DSL subscribers we serve grew substantially. We had 52,732, 39,192 and 27,445 DSL lines in service as of December 31, 2006, 2005 and 2004, respectively. Currently over 92% of our rural telephone companies' local access lines are DSL capable. The penetration rate for DSL lines in service was approximately 31.0% of our primary residential access lines at December 31, 2006.

We have also been successful in generating Telephone Operations revenues by bundling combinations of local service, custom calling features, voicemail and Internet access. Our service bundles totaled 43,175, 36,627 and 30,489 at December 31, 2006, 2005 and 2004, respectively.

Our plan is to continue to execute our customer retention program by delivering excellent customer service and improving the value of our bundle with DSL and IPTV. However, if these actions fail to mitigate access line loss, or we experience a higher degree of access line loss than we currently expect, it could have an adverse impact on our revenues and earnings.

The following sets forth several key metrics as of the end of the periods presented:

	December 31,		
	2006	2005	2004
Local access lines in service:			
Residential	155,354	162,231	168,778
Business	78,335	79,793	86,430
Total local access lines	<u>233,689</u>	<u>242,024</u>	<u>255,208</u>
IPTV subscribers	6,954	2,146	101
DSL subscribers	52,732	39,192	27,445
Broadband connections	59,686	41,338	27,546
Total connections	<u>293,375</u>	<u>283,362</u>	<u>282,754</u>
Long distance lines	148,181	143,882	138,677
Dial-up subscribers	11,942	15,971	21,184
Service bundles	43,175	36,627	30,489

Expenses

Our primary operating expenses consist of cost of services, selling, general and administrative expenses and depreciation and amortization expenses.

Cost of Services and Products

Our cost of services includes the following:

- operating expenses relating to plant costs, including those related to the network and general support costs, central office switching and transmission costs and cable and wire facilities;

- general plant costs, such as testing, provisioning, network, administration, power and engineering; and
- the cost of transport and termination of long distance and private lines outside our rural telephone companies' service area.

We have agreements with carriers to provide long distance transport and termination services. These agreements contain various commitments and expire at various times. We believe we will meet all of our commitments in these agreements and believe we will be able to procure services for future periods. We are currently procuring services for future periods, and at this time, the costs and related terms under which we will purchase long distance transport and termination services have not been determined. We do not expect, however, any material adverse affects from any changes in any new service contract.

Selling, General and Administrative Expenses

In general, selling, general and administrative expenses include the following:

- selling and marketing expenses;
- expenses associated with customer care;
- billing and other operating support systems; and
- corporate expenses, including professional service fees, and non-cash stock compensation.

Our Telephone Operations segment incurs selling, marketing and customer care expenses from its customer service centers and commissioned sales representatives. Our customer service centers are the primary sales channels for residential and business customers with one or two phone lines, whereas commissioned sales representatives provide customized proposals to larger business customers. In addition, we use customer retail centers for various communications needs, including new telephone, Internet and paging service purchases in Illinois.

Each of our Other Operations businesses primarily uses an independent sales and marketing team comprised of dedicated field sales account managers, management teams and service representatives to execute our sales and marketing strategy.

We have operating support and back office systems that are used to enter, schedule, provision and track customer orders, test services and interface with trouble management, inventory, billing, collections and customer care service systems for the local access lines in our operations. We have migrated most key business processes of our Illinois and Texas operations onto single, company-wide systems and platforms. Our objective is to improve profitability by reducing individual company costs through centralization, standardization and sharing of best practices. For the years ended December 31, 2006, 2005 and 2004 we spent \$2.9 million, \$7.4 million and \$7.0 million, respectively, on integration and restructuring expenses (which included projects to integrate our support and back office systems). We expect to continue the integration of our Illinois and Texas billing systems through September 2007.

Depreciation and Amortization Expenses

We recognize depreciation expenses for our regulated telephone plant using rates and lives approved by the ICC and the PUCT. The provision for depreciation on nonregulated property and equipment is recorded using the straight-line method based upon the following useful lives:

	<u>Years</u>
Buildings	15-35
Network and outside plant facilities	5-30
Furniture, fixtures and equipment	3-17

Amortization expenses are recognized primarily for our intangible assets considered to have finite useful lives on a straight-line basis. In accordance with Statement of Financial Accounting Standards, or SFAS, No. 142, *Goodwill and Other Intangible Assets*, goodwill and intangible assets that have indefinite useful lives are not amortized but rather are tested annually for impairment. Because trade names have been determined to have indefinite lives, they are not amortized. Customer relationships are amortized over their useful life, at a weighted average life of approximately 12 years.

The following summarizes our revenues and operating expenses on a consolidated basis for the years ended December 31, 2006, 2005 and 2004:

	Year Ended December 31,					
	2006		2005		2004	
	\$ (millions)	% of Total Revenues	\$ (millions)	% of Total Revenues	\$ (millions)	% of Total Revenues
Revenues						
Telephone Operations						
Local calling services	\$ 85.1	26.6%	\$ 88.2	27.4%	\$ 74.9	27.8%
Network access services	68.1	21.2	64.4	20.0	56.8	21.1
Subsidies	47.6	14.8	53.9	16.8	40.5	15.0
Long distance services	15.2	4.7	16.3	5.1	14.7	5.5
Data and internet services	30.9	9.6	25.8	8.0	20.9	7.8
Other services	33.5	10.5	33.7	10.5	22.6	8.4
Total Telephone Operations	280.4	87.4	282.3	87.8	230.4	85.5
Other Operations	40.4	12.6	39.1	12.2	39.2	14.5
Total operating revenues	320.8	100.0	321.4	100.0	269.6	100.0
Expenses						
Operating expenses						
Telephone Operations	155.2	48.4	165.0	51.3	133.5	49.5
Other Operations	48.9	15.2	34.9	10.9	46.6	17.3
Depreciation and amortization	67.4	21.0	67.4	21.0	54.5	20.2
Total operating expenses	271.5	84.6	267.3	83.2	234.6	87.0
Income from operations	49.3	15.4	54.1	16.8	35.0	13.0
Interest expense, net	(42.9)	(13.4)	(53.4)	(16.6)	(39.6)	(14.7)
Other income, net	7.3	2.3	5.7	1.8	3.7	1.4
Income tax expense	(0.4)	(0.1)	(10.9)	(3.4)	(0.2)	(0.1)
Net income (loss)	\$ 13.3	4.1%	\$ (4.5)	(1.4%)	\$ (1.1)	(0.4%)

Segments

In accordance with the reporting requirement of SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*, the Company has two reportable business segments, Telephone Operations and Other Operations. The results of operations discussed below reflect our consolidated results.

Results of Operations***For the Year Ended December 31, 2006 Compared to December 31, 2005******Revenues***

Our revenues decreased by 0.2%, or \$0.6 million, to \$320.8 million in 2006, from \$321.4 million in 2005. Our discussion and analysis of the components of the variance follows:

Telephone Operations Revenues

Local calling services revenues decreased by 3.5% or \$3.1 million, to \$85.1 million in 2006 compared to \$88.2 million in 2005. The decrease is primarily due to the decline in local access lines as previously discussed under “—Factors Affecting Results of Operations.”

Network access services revenues increased by 5.7%, or \$3.7 million, to \$68.1 million in 2006 compared to \$64.4 million in 2005. The increase was primarily driven by increased demand for point-to-point circuits and other network access services.

Subsidies revenues decreased by 11.7%, or \$6.3 million, to \$47.6 million in 2006 compared to \$53.9 million in 2005. The decrease is primarily due to the timing of out of period settlements in 2005 compared to 2006. In 2005 we received \$1.7 million in prior period receipts and we refunded \$1.3 million in 2006. The remainder of the decrease is attributable to declines in Universal Service Fund draws associated with lower recoverable expenses and an increase in the national average cost per loop, which resulted in lower subsidies to rural carriers.

Long distance services revenues decreased by 6.7%, or \$1.1 million, to \$15.2 million in 2006 compared to \$16.3 million in 2005. This was driven by general industry trends and the introduction of our unlimited long distance calling plans. While these plans are helpful in maintaining existing customers and attracting new customers, they have also led to some extent to a reduction in long distance services revenues as heavy users of our long distance services take advantage of the fixed pricing offered by these service plans.

Data and Internet revenues increased by 19.8%, or \$5.1 million, to \$30.9 million in 2006 compared to \$25.8 million in 2005. The revenue increase was due to increased DSL and IPTV penetration. The number of DSL lines in service increased from 39,192 as of December 31, 2005 to 52,732 as of December 31, 2006. IPTV customers increased from 2,146 at December 31, 2005 to 6,954 at December 31, 2006. These increases were partially offset by erosion of our dial-up Internet base, which decreased from 15,971 subscribers at of December 31, 2005 to 11,942 at December 31, 2006.

Other Services revenues remained relatively steady at \$33.5 million in 2006 compared to \$33.7 million in 2005.

Other Operations Revenue

Other Operations revenues increased by 3.3%, or \$1.3 million, to \$40.4 million in 2006 compared to \$39.1 million in 2005. Revenues from our telemarketing and order fulfillment business increased by \$1.5 million due to increased sales to existing customers. Our prison systems unit generated increased revenue of \$0.8 million for the period from increased minutes of use. These increases were partially offset by a net \$1.0 million decrease in revenues associated with our other ancillary operations, primarily from our operator services business which experienced losses due to increased competition.

CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)
(Dollars in thousands, except share and per share amounts)

6. Property, plant and equipment

Property, plant, and equipment, net consist of the following:

	December 31,	
	2006	2005
Property, plant and equipment:		
Land and buildings	\$ 49,346	\$ 48,015
Network and outside plant facilities	670,791	657,308
Furniture, fixtures and equipment	74,082	75,161
Work in process	4,124	6,480
	798,343	786,964
Less: accumulated depreciation	(483,962)	(451,876)
Net property, plant and equipment	\$ 314,381	\$ 335,088

Depreciation expense totaled \$53,170, \$53,089 and \$42,652 in 2006, 2005 and 2004, respectively.

7. Investments

Investments consist of the following:

	December 31,	
	2006	2005
Cash surrender value of life insurance policies	\$ 1,376	\$ 1,259
Cost method investments:		
GTE Mobilnet of South Texas Limited Partnership	21,450	21,450
Rural Telephone Bank stock	—	5,921
CoBank, ACB stock	2,251	2,071
Other	18	19
Equity method investments:		
GTE Mobilnet of Texas RSA #17 Limited Partnership (17.02% owned)	15,080	13,175
Fort Bend Fibernet Limited Partnership (39.06% owned)	139	161
	\$ 40,314	\$ 44,056

The Company has a 2.34% ownership of GTE Mobilnet of South Texas Limited Partnership (the "Mobilnet South Partnership"). The principal activity of the Mobilnet South Partnership is providing cellular service in the Houston, Galveston and Beaumont, Texas metropolitan areas.

The Company has a 17.02% ownership of GTE Mobilnet of Texas RSA #17 Limited Partnership (the "Mobilnet RSA Partnership"). The principal activity of the Mobilnet RSA Partnership is providing cellular service to a limited rural area in Texas. The Company has some influence on the operating and financial policies of this partnership and accounts for this investment on the equity basis. Summarized financial information for the Mobilnet RSA Partnership was as follows:

CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)
(Dollars in thousands, except share and per share amounts)

	<u>2006</u>	<u>2005</u>
For the year ended December 31:		
Total revenues	\$ 49,298	\$ 42,032
Income from operations	15,161	10,959
Income before income taxes	15,633	11,260
Net income	15,633	11,260
As of December 31:		
Current assets	14,409	10,140
Non-current assets	34,399	29,183
Current liabilities	2,465	2,722
Non-current liabilities	246	137
Partnership equity	46,097	36,464

The Company received partnership distributions totaling \$1,099 and \$379 from its equity method investments in 2006 and 2005, respectively.

8. Minority Interest

East Texas Fiber Line, Inc. ("ETFL") is a joint venture owned 63% by the Company and 37% by Eastex Celco. ETFL provides connectivity to certain customers within Texas over a fiber optic transport network.

9. Goodwill and Other Intangible Assets

In accordance with SFAS 142, goodwill and tradenames are not amortized but are subject to an annual impairment test, or to more frequent testing if circumstances indicate that they may be impaired. In December 2006 and 2005, the Company completed its annual impairment test, using a discounted cash flow method, and the test indicated no impairment of goodwill existed. In December 2004, the Company completed its annual impairment test and determined that goodwill was impaired in one of its reporting units within the Other Operations segment of the Company, and a resulting goodwill impairment charge of \$10,147 was recognized. The goodwill impairment was limited to the Company's Operator Services reporting unit, and was due to a decline in current and projected cash flows for this reporting unit.

The following table presents the carrying amount of goodwill by segment:

	<u>Telephone Operations</u>	<u>Other Operations</u>	<u>Total</u>
Balance at January 1, 2005	\$ 309,527	\$ 8,954	\$ 318,481
Finalization of TXUCV purchase accounting and other adjustments, net	(4,238)	—	(4,238)
Balance at December 31, 2005	305,289	8,954	314,243
Adjustment for change in estimate of tax basis of acquired assets	1,791	—	1,791
Reclassification	1,770	(1,770)	—
Balance at December 31, 2006	<u>\$ 308,850</u>	<u>\$ 7,184</u>	<u>\$ 316,034</u>

CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)
(Dollars in thousands, except share and per share amounts)

The Company's most valuable tradename is the federally registered mark CONSOLIDATED, which is used in association with our telephone communication services and is a design of interlocking circles. The Company's corporate branding strategy leverages a CONSOLIDATED naming structure. All business units and several product/services names incorporate the CONSOLIDATED name. These tradenames are indefinitely renewable intangibles. In December 2006, the Company completed its annual impairment test using discounted cash flows based on a relief from royalty method and determined that the recorded value of its tradename was impaired in the Operator Services reporting unit within the Other Operations segment of the Company, and a resulting impairment charge of \$255 was recognized. In December 2005, similar testing indicated no impairment of the Company's tradenames existed. In December 2004, the Company determined that the recorded value of its tradename was impaired in two of its reporting units within the Other Operations segment of the Company, and a resulting impairment charge of \$1,431 was recognized. The 2004 tradename impairment was limited to the Company's Operator Services and Mobile Services reporting units. Both the 2006 and the 2004 tradename impairments were due to lower than previously anticipated revenues within the applicable reporting units.

The carrying value of the Company's tradenames totaled \$14,291 and \$14,546 at December 31, 2006 and 2005, respectively. The value of the tradenames was allocated to the business segments as follows: \$10,557 to the Telephone Operations and \$3,734 to the Other Operations as of December 31, 2006.

The Company's customer lists consist of an established core base of customers that subscribe to its services. In December 2006, the Company identified a decline in current and projected cash flows from customers associated with the customer lists within two of its reporting units. The Company completed an impairment test and determined that the value of its customer list was partially impaired and a resulting impairment charge of \$10,985 was recognized. The customer list impairment was limited to the Company's Operator Services and Telemarketing Services reporting units within the Other Operations segment of the Company.

The carrying amount of customer lists is as follows:

	December 31,	
	2006	2005
Gross carrying amount	\$ 156,648	\$ 167,633
Less: accumulated amortization	(46,375)	(32,118)
Net carrying amount	\$ 110,273	\$ 135,515

The net carrying value of the customer lists were allocated to the business segments as follows: \$107,081 to the Telephone Operations and \$3,192 to the Other Operations as of December 31, 2006. The aggregate amortization expense associated with customer lists for the years ended December 31, 2006, 2005 and 2004 was \$14,260, \$14,290 and \$11,870, respectively. Customer lists are being amortized using a weighted average life of approximately 12 years. The estimated annual amortization expense is \$12,436 for each of the next five years.

10. Affiliated Transactions

Agracel, Inc., or Agracel, is a real estate investment company of which Richard A. Lumpkin, Chairman of the Company, together with his family, beneficially owns 49.7%. In addition, Mr. Lumpkin is a director of Agracel. Agracel is the sole managing member and 50% owner of LATEL LLC ("LATEL"). Mr. Lumpkin directly owns the remaining 50% of LATEL. The Company leases certain office and warehouse space from LATEL. The leases are triple net leases that require the Company to pay substantially all expenses associated with general maintenance and repair, utilities, insurance and taxes associated with the leased facilities. The Company recognized rent expense of \$1,320, \$1,285 and \$1,251 during 2006, 2005 and 2004, respectively, in connection with these operating leases. There is no associated lease payable balance outstanding at December 31, 2006. The leases expire in September 2011.

CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(Dollars in thousands, except share and per share amounts)

Agracel is the sole managing member and 66.7% owner of MACC, LLC (“MACC”). Mr. Lumpkin, together with his family, owns the remainder of MACC. The Company leases certain office space from Agracel. The Company recognized rent expense in the amount of \$132, \$139 and \$123 during 2006, 2005 and 2004, respectively, in connection with this lease.

Mr. Lumpkin, together with members of his family, beneficially owns 100% of SKL Investment Group, LLC (“SKL”). The Company charged SKL \$45 in 2006 and \$77 in both 2005 and 2004 for use of office space, computers, telephone service and other office related services.

Mr. Lumpkin also has an ownership interest in First Mid-Illinois Bancshares, Inc. (“First Mid-Illinois”) which provides the Company with general banking services, including depository, disbursement and payroll accounts and retirement plan administrative services, on terms comparable to those available to other large business accounts. The Company provides certain telecommunications products and services to First Mid-Illinois. Those services are based upon standard prices for strategic business customers. Following is summary of the transactions between the Company and First Mid-Illinois:

	Year ended December 31,		
	2006	2005	2004
Fees charged from First Mid-Illinois for:			
Banking fees	\$ 10	\$ 6	\$ 5
401K plan administration	100	69	77
Interest income earned by the Company on deposits at First Mid-Illinois	206	443	170
Fees charged by the Company to First Mid-Illinois for telecommunication services	542	514	476

A wholly owned insurance brokerage subsidiary of First Mid-Illinois maintains a co-brokerage arrangement with Arthur J. Gallagher Risk Management Services, Inc. (“AJG Risk Management”). The Company paid insurance premiums of approximately \$2,000, \$2,210 and \$2,015 during 2006, 2005 and 2004, respectively, to independent insurance providers under policies brokered by AJG Risk Management.

Prior to the IPO, the Company and certain of its subsidiaries maintained two professional services fee agreements. The agreements required the Company to pay to Richard A. Lumpkin, Chairman of the Company, Providence Equity and Spectrum Equity professional services fees to be divided equally among them, for consulting, advisory and other professional services provided to the Company. The Company recognized fees totaling \$2,867 and \$4,135 during 2005 and 2004, respectively, associated with these agreements. These fees are included in selling, general and administrative expenses in the Consolidated Statements of Operations. Effective July 27, 2005, in connection with the IPO, these agreements were cancelled.



Form 10-K

IOWA TELECOMMUNICATIONS SERVICES INC - IWA

Filed: March 05, 2007 (period: December 31, 2006)

Annual report which provides a comprehensive overview of the company for the past year

Table of Contents

PART I.

3

- ITEM 1. Business 3
- ITEM 1. Business
- ITEM 1A. Risk Factors
- ITEM 1B. Unresolved Staff Comments
- ITEM 2. Properties
- ITEM 3. Legal Proceedings
- ITEM 4. Submission of Matters to a Vote of Security Holders

PART II.

- ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of E
- ITEM 6. Selected Financial Data
- ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations
- ITEM 7A. Quantitative And Qualitative Disclosures About Market Risk
- ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
- ITEM 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
- ITEM 9A. Controls And Procedures
- ITEM 9B. Other Information

PART III.

- ITEM 10. Directors, Executive Officers of the Registrant and Corporate Governance
- ITEM 11. Executive Compensation
- ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matt
- ITEM 13. Certain Relationships and Related Transactions and Director Independence
- ITEM 14. Principal Accountant Fees and Services

PART IV.

- ITEM 15. Exhibits and Financial Statement Schedules
- SIGNATURES
- INDEX TO EXHIBITS

EX-21 (SUBSIDIARIES OF IOWA TELECOMMUNICATIONS SERVICES)

EX-23.1 (CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM)

EX-31.1 (CERTIFICATION)

EX-31.2 (CERTIFICATION)

EX-32.1 (CERTIFICATION)

EX-32.2 (CERTIFICATION)

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 001-32354

IOWA TELECOMMUNICATIONS SERVICES, INC.

(Exact name of registrant as specified in its charter)

IOWA
(State or Other Jurisdiction of
Incorporation or Organization)

42-1490040
(I.R.S. Employer
Identification No.)

115 S. Second Avenue West
Newton, Iowa 50208
(Address of principal executive offices)

Registrant's telephone number, including area code: (641) 787-2000

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 \$0.01 per share	New York Stock Exchange

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

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

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

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 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. Yes 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 Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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

The aggregate market value of the shares of all classes of voting stock of the registrant held by non-affiliates of the registrant as of June 30, 2006, was approximately \$544,355,815 computed upon the basis of the closing sales price of those shares on the New York Stock Exchange on that date. For purposes of this computation, shares held by directors (and shares held by any entities in which they serve as officers) and officers of the registrant have been excluded.

There were 31,718,970 shares of Common Stock, \$0.01 par value, outstanding as of February 28, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

The definitive proxy statement relating to the Registrant's 2007 Annual Meeting of Shareholders, which will be filed pursuant to Regulation 14A, is incorporated by reference in Part III to the extent described therein.

Table of Contents

TABLE OF CONTENTS.

	<u>PAGE</u>
<u>PART I.</u>	3
ITEM 1. <u>Business</u>	3
ITEM 1A. <u>Risk Factors</u>	22
ITEM 1B. <u>Unresolved Staff Comments</u>	33
ITEM 2. <u>Properties</u>	33
ITEM 3. <u>Legal Proceedings</u>	33
ITEM 4. <u>Submission of Matters to a Vote of Security Holders</u>	33
<u>PART II.</u>	34
ITEM 5.	34
	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>
ITEM 6.	37
	<u>Selected Financial Data</u>
ITEM 7.	40
	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>
ITEM 7A.	60
	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
ITEM 8.	61
	<u>Financial Statements and Supplementary Data</u>
ITEM 9.	92
	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>
ITEM 9A.	92
	<u>Controls and Procedures</u>
ITEM 9B.	94
	<u>Other Information</u>
<u>PART III.</u>	95
ITEM 10.	95
	<u>Directors, Executive Officers of the Registrant and Corporate Governance</u>
ITEM 11.	95
	<u>Executive Compensation</u>
ITEM 12.	95
	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>
ITEM 13.	95
	<u>Certain Relationships and Related Transactions and Director Independence</u>
ITEM 14.	95
	<u>Principal Accountant Fees and Services</u>
<u>PART IV.</u>	96
ITEM 15.	96
	<u>Exhibits and Financial Statement Schedules</u>
<u>SIGNATURES</u>	97
<u>INDEX TO EXHIBITS</u>	99

Table of Contents**Forward-Looking Statements**

The statements contained in this Report on Form 10-K that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding our expectations, objectives, anticipations, plans, hopes, beliefs, intentions or strategies regarding the future.

Forward-looking statements in this report, including without limitation, those set forth under the captions "Business," "Dividend Policy and Restrictions," "Legal Proceedings" and "Management's Discussion and Analysis of Financial Condition and Results of Operations," and statements relating to our plans, strategies, objectives, expectations, intentions and adequacy of resources, are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995.

The words "believes," "anticipates," "expects," "intends," "plans," "estimates," "projects," "will," "should," "continues" and similar expressions are intended to identify forward-looking statements. These forward-looking statements reflect our current views with respect to future events and financial performance and are subject to risks and uncertainties, including those identified under "Business," "Dividend Policy and Restrictions," "Legal Proceedings" and "Management's Discussion and Analysis of Financial Condition and Results of Operations," as well as:

- technological developments and changes in the telecommunications industry;
- increased price and service competition;
- changes in federal and state legislation and the rules and regulations enacted pursuant to that legislation;
- regulatory limitations on our ability to change our pricing for communications services;
- possible changes in the demand for our products and services; and
- the matters described under Item 1A, "Risk Factors."

In addition to these factors, actual future performance, outcomes and results may differ materially from those indicated in our forward-looking statements because of other, more general factors, including (without limitation):

- changes in general industry and market conditions and growth rates;
- changes in interest rates or other general national, regional or local economic conditions;
- governmental and public policy changes;
- changes in accounting policies or practices adopted voluntarily or as required by GAAP; and
- continued availability of financing in the amounts and on the terms and conditions necessary to support our future business.

All forward-looking statements included in this document are based on information available to us on the date hereof, and we assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from those included in such forward-looking statements.

General Information

We maintain a website at www.iowatelecom.com to provide information to the general public and our shareholders about our products and services, along with general information about Iowa Telecommunications Services, Inc. ("Iowa Telecom") and its management, financial results and press releases. Copies of our most recent Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q and our other reports filed with the Securities and Exchange Commission, or SEC, can be obtained, free of charge, as soon as reasonably practicable

Table of Contents

after such material is electronically filed with, or furnished to, the SEC from our investor relations department by calling (641) 787-2089, through an e-mail request from our website at www.iowatelecom.com, through our website by clicking the direct link from our "Investor Relations" page on our website or directly from the SEC's website at www.sec.gov. Our website and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K.

Our Board of Directors has adopted a Code of Business Conduct and Ethics that is applicable to all of our directors, officers and employees. Any material changes made to our Code of Business Conduct and Ethics or any waivers granted to any of our directors or executive officers will be publicly disclosed by filing a current report on Form 8-K within four business days of such material change or waiver. There were no material changes to the code or waivers granted during 2006. Our Board of Directors also has adopted Corporate Governance Guidelines and written charters for its Audit, Compensation, and Nominating and Governance committees that comply with the rules of the New York Stock Exchange. Copies of the Code of Business Conduct and Ethics, our Corporate Governance Guidelines, and the charters of the Audit, Compensation, and, Nominating and Governance committees are available on our website at www.iowatelecom.com. In addition, these documents are available upon request by contacting our investor relations department at (641) 787-2089 or through an e-mail request from our website at www.iowatelecom.com.

This Annual Report on Form 10-K includes the certifications required of our chief executive officer and our chief financial officer by Section 302 of the Sarbanes-Oxley Act. In addition, the annual certification of the chief executive officer regarding compliance by the company with the corporate governance listing standards of the New York Stock Exchange was submitted without qualification following the 2006 annual meeting of shareholders.

Table of Contents**PART I.****ITEM 1. Business****Company Overview**

We are the largest provider of wireline local exchange telecommunications services to residential and business customers in rural Iowa, serving over 440 communities across the state. We are the second largest local exchange carrier in Iowa and estimated to be in the top 20 largest in the United States. We currently operate 288 telephone exchanges as the incumbent or "historical" local exchange carrier and are currently the sole telecommunications company providing wireline services in approximately 85% of these exchanges. Together with our competitive local exchange carrier subsidiaries, we provide services to approximately 252,000 access lines in Iowa.

Our core businesses are local telephone service and the provision of network access to other telecommunications carriers for calls originated or terminated on our network. These businesses generated 74% of our total revenues for the year ended December 31, 2006.

In addition to our basic local service and network access businesses, we provide long distance service, dial-up and DSL Internet access and other communications services. Our strong incumbent market position gives us a platform to cross-sell these additional services to our customers. In 2002, as part of our strategy of pursuing low-cost growth beyond our current service area, we began to compete for customers in adjacent markets in Iowa through our competitive local exchange carrier subsidiary, Iowa Telecom Communications, Inc. ("ITC"). In late 2005, IT Communications, LLC ("IT Communications") was formed to operate similarly to ITC but with a focus on larger communities in Iowa.

We believe we are building strong consumer loyalty and brand recognition by providing superior, locally focused customer service and maintaining strong ties to our rural communities. Our stable customer base, combined with the higher costs of offering competitive wireline services, leads to limited competition in the rural regions we serve as compared to most urban areas.

Our History

In the late 1990's, several of the Regional Bell Operating Companies and other large telecommunications companies, such as GTE Midwest Incorporated, decided to sell many of their rural assets. Many of these large providers had decided to focus investment capital and resources on their urban markets and national wireless and business service operations, rather than on their rural markets, which we believe were historically underserved by the large providers. We concluded that GTE Midwest Incorporated's divestiture of its rural Iowa operations presented an attractive opportunity to improve the financial performance of this business by improving existing networks, offering customers additional services and providing high quality, locally focused customer service. We were incorporated under the laws of the State of Iowa in 1999. We began business on June 30, 2000 when we acquired the Iowa operations of GTE Midwest Incorporated. Our common stock began trading on the New York Stock Exchange on November 18, 2004 under the trading symbol "IWA."

We are the largest provider of wireline telecommunications services to rural communities in Iowa. We are the sole telecommunications company currently providing wireline services in approximately 85% of our incumbent local exchanges. Our incumbent market position has allowed us to pursue increased revenues per access line by cross-selling additional services to existing subscribers, including offering integrated packages, or bundles, of local, long distance and Internet service on a single monthly customer bill. Since the GTE Midwest Incorporated acquisition, we have expanded our toll, or long distance, services and have introduced dial-up and DSL Internet access as profitable new businesses.

Virtually all of our services are offered in an area that is 20,000 square miles in size, and each of our switching centers is within 30 miles of another of our switching centers. This geographic concentration allows us

Table of Contents

to efficiently manage our network operations and to cost-effectively generate a local brand identity, and also leads to a higher degree of customer contact. Over 99% of the customers we serve are located in rural communities in the state of Iowa. Our single-state focus also raises our profile in Iowa and spares us the complexity, cost and unpredictability of operating under multiple state regulatory regimes.

On July 1, 2006, we completed the purchase of the Montezuma Mutual Telephone Company ("Montezuma Telephone"). Montezuma Telephone provides telecommunications services to 2,100 access lines, cable television service to approximately 1,350 subscribers and Internet access service to more than 950 subscribers, most of which are located in Montezuma, Iowa.

On August 1, 2006, we completed the purchase of Baker Communications, Inc. ("Baker Communications"). Baker Communications designs, develops, and provides ongoing support of technology solutions for clients. Areas of specialization include enterprise voice solutions, Internet protocol ("IP") communications and data networking. Baker Communications is headquartered in Des Moines, Iowa, with additional offices in Cedar Rapids, Iowa and Omaha, Nebraska.

Our Strategy

Our objective is to continue to strengthen our position as a leading provider of telecommunications services, focusing primarily on non-metropolitan markets in the Midwest. To achieve this goal, we intend to pursue the following strategies:

- *Maintain Stable Cash Flows from Operations and Disciplined Capital Spending.* We have a diverse residential and business customer base that produces a recurrent revenue stream and relatively predictable cash flows. We intend to maintain our financial performance by continuing to grow revenue and improve operating efficiency throughout our businesses. We make disciplined capital expenditure decisions, focusing on investments made for maintaining high quality service, cost structure improvement, and cash flow generation.
- *Leverage and Enhance Local Presence and Customer Loyalty.* We have a strong commitment to local presence and customer relationships. We have created a community relations staff dedicated to maintaining relationships with local leaders and civic organizations. As a result of this and other initiatives, we believe Iowa Telecom has developed a brand identity as a responsive, locally oriented service provider. We intend to use this strong reputation to maintain our competitive market position, cross-sell additional services to our current subscribers and expand our existing customer base.
- *Increase Revenue per Access Line by Selling Additional and Enhanced Services.* We actively market long distance service, dial-up and DSL Internet access service, satellite video service and enhanced local services (such as call waiting, caller ID and voice mail) to our local customers as bundled services billed on the same monthly statement the customer receives for basic local service. We have demonstrated success in cross-selling these services to our customer base. The following table shows the average revenue per access line from some of these additional services for the years ended December 31, 2004, 2005 and 2006:

Service	Additional and Enhanced Services Average Revenue Per Access Line(1)		
	Year Ended December 31,		
	2004	2005	2006
Toll (long distance)	\$ 87	\$ 91	\$ 85
Dial-up Internet	41	37	30
DSL	21	42	66
Enhanced local services	24	29	33
Total	\$ 173	\$ 199	\$ 214

- (1) Average revenue per access line is computed by dividing the total revenue for the specified service for the period by the average of the access lines at the beginning of the period and the end of the period.

Table of Contents

We intend to pursue increased sales of these services to our existing customers and, where appropriate, to introduce ancillary services to our customers.

- *Prudent Expansion of Our Service Area Through our Competitive Local Exchange Carrier Subsidiaries.* We intend to leverage our strong local presence, superior customer service and economies of scale to pursue customers in markets adjacent to our rural local exchange carrier markets through our competitive local exchange carrier subsidiaries, ITC and IT Communications. We plan to continue this strategy by seeking growth opportunities on a low-cost, selective basis. In 2007, we plan to maintain this limited investment approach as we continue to grow our competitive local exchange carrier business.
- *Grow Through Selective Strategic Acquisitions.* We intend to continue pursuing a disciplined process of evaluating select acquisitions of access lines from Regional Bell Operating Companies and other rural local exchange carriers, as well as evaluating acquisitions of providers of businesses complementary to ours. Over the past several years, Regional Bell Operating Companies have divested a significant number of access lines nationwide and are expected to continue these divestitures in order to focus on larger markets. We also believe there may be attractive opportunities to acquire rural local exchange carriers, which we believe will likely consolidate as competitive pressures intensify. In Iowa alone, there are approximately 150 rural local exchange carriers serving a fragmented market representing approximately 230,000 access lines. One of our key acquisition criteria will be the potential of any proposed transaction to increase our free cash flow per share.

Products, Services and Revenue Sources

We provide wireline local exchange telecommunications services to residential and business customers in over 440 communities throughout Iowa through our incumbent local exchange carrier and our competitive local exchange carrier subsidiaries. Approximately 74% of our access lines serve residential customers and 26% serve business customers. We generate revenues by providing our customers:

- local services, which include basic local telephone service and enhanced local services like voice mail, caller ID and call forwarding;
- network access services to interexchange carriers for the origination and termination of interstate and intrastate long distance phone calls on our network;
- toll (also known as long distance) services; and
- other services and sales, including dial-up and DSL Internet access service, satellite video and the sale, installation and maintenance of customer premise voice and data equipment.

We complement our basic local telephone services by actively marketing products under the Iowa Telecom brand. We believe that our ability to cross-sell to our customer base in this way is bolstered by the fact that we are currently the sole local telecommunications provider in approximately 85% of the exchanges we serve as the incumbent carrier. The following table shows our revenues and sales for each of the years ended December 31, 2004, 2005 and 2006 by category of service:

	Year Ended December 31,					
	2004(1)		2005		2006	
	Amount	Percent	Amount	Percent	Amount	Percent
Local services	\$ 82,778	36%	\$ 75,581	33%	\$ 76,428	33%
Network access services	94,957	42%	101,227	44%	96,217	41%
Toll services	23,167	10%	23,813	10%	21,804	9%
Other services and sales	27,217	12%	31,019	13%	39,636	17%
Total revenues and sales	\$ 228,119	100%	\$ 231,640	100%	\$ 234,085	100%

- (1) Local services revenue for the year ended December 31, 2004 includes the recognition, as a result of our rate settlement agreement with the Iowa Utilities Board in April 2004, of \$7.1 million of revenue that we

Table of Contents

had collected in prior periods subject to refund. Excluding the prior period revenue, the percent of total revenues and sales for the year ended December 31, 2004 attributable to local services, network access services, toll services and other services and sales was 34%, 43%, 11%, and 12%, respectively.

Local Services

Basic local services enable end user customers to make and receive telephone calls within a defined local calling area for a flat monthly fee. The maximum amount that we may charge for basic local service for residential and single line business customers is determined by the Iowa price regulation plan under which we operate. We also provide Extended Area Services, a mandatory expanded calling service to selected nearby communities at a flat monthly rate, which is also considered to be a basic monthly service.

In addition to subscribing to basic local telephone services, our customers may choose from a variety of enhanced or non-basic communications services which are also classified as local services. These include call waiting, call forwarding, caller ID, voice mail and three-way calling and are billed on the customer's monthly bill for basic local service. Offering such services to local customers through bundled service packages is an important part of our strategy to increase average revenue per subscriber.

Network Access Services

We bill access charges to other carriers for the use of our facilities to terminate or originate long distance calls on our network. These fees relate to interexchange long distance, or toll calls, that involve more than one company in the provision of the service. Network access charges compensate us for the services we provide to other carriers for completing toll calls for our customers.

We generate network access revenues under two jurisdictions. We generate intrastate access revenues for providing either switched or special access services when a long distance call is placed or received by a customer in one of our exchanges, to or from another party located in Iowa. The toll carrier pays us an intrastate access charge, the level of which is regulated and approved by the Iowa Utilities Board. We generate interstate access revenues for providing either switched or special access services when a long distance call is originated or terminated by a customer calling from one state to a customer in another state and one of the parties is a local service customer of ours. We bill interstate access charges in the same manner as we bill intrastate access charges. Interstate access charges are regulated and approved by the FCC.

Additionally, we bill subscriber line charges, or SLC's, to substantially all of our end user customers for access to the public switched network. The monthly subscriber line charges are regulated and approved by the FCC.

We also bill wireless carriers for certain traffic transport and termination services unrelated to intrastate or interstate access service. These charges are governed by interconnection agreements with the wireless carriers.

Toll Services

We began offering toll, or long distance, services in July 2000 through sales to our established customer base. We have leveraged our customer relationships and single billing approach to achieve revenue growth for toll service with minimal need for additional capital expenditures. The following table shows our number of toll service subscribers as of the date shown:

<u>Subscribers as of December 31,</u>		
<u>2004</u>	<u>2005</u>	<u>2006</u>
135,800	142,800	146,600

Table of Contents

We market long distance service under our Iowa Telecom brand name, but we provide service through resale arrangements we have with a variety of carriers. Long distance revenues are earned as our long distance customers place calls, with charges generally based on the length of the call and the applicable per-minute rate. Some customers pay a fixed minimum monthly charge for our long distance service independent of calls actually made. In order to offer attractively priced options to our customers, we often bundle long distance service with our local services, dial-up and DSL Internet access offerings.

Other Services and Sales

Other services and sales consists largely of revenues generated by our dial-up and DSL Internet access services and the sale, installation and maintenance of the customer premise voice and data equipment. We began offering dial-up internet access service in 2000, and DSL Internet access service in a few markets in late 2001. We currently have DSL equipment installed in all of our 288 incumbent exchanges. We estimate that we are currently capable of providing DSL Internet access service to approximately 75% of our access lines. Approximately 32% of our access line customers subscribe to our dial-up or DSL Internet service. The following table shows our number of dial-up and DSL Internet access service subscribers as of the dates shown.

Service	Subscribers as of December 31,		
	2004	2005	2006
Dial-up Internet	51,500	41,700	31,500
DSL	15,600	31,200	50,000
Total	67,100	72,900	81,500

Competitive Local Exchange Carrier Services

We currently provide competitive local exchange carrier services through our wholly-owned subsidiaries, ITC and IT Communications (sometimes referred to together as "the CLEC"). The CLEC currently offers a broad range of traditional and enhanced wireline communications services to business and residential customers in 21 exchanges throughout Iowa. As of December 31, 2006, the CLEC served approximately 23,800 total access lines. We view our competitive local exchange carrier business as a cost-effective way to leverage our Iowa Telecom brand and corporate infrastructure into markets adjacent to those served by our incumbent local exchange carrier operations. Our primary strategy has been to target contiguous markets that historically have been underserved and subject to minimal competition. In these markets, we can compete cost effectively through our interconnection agreements with the incumbent provider, pursuant to which we may lease lines on a "wholesale" basis.

We have historically entered selected exchanges by utilizing a low-risk unbundled network element platform. This entry strategy permitted us to use the incumbent carrier's existing loop and switches and thus required minimal upfront capital investment on our part. Although the FCC has revised the rules that govern the availability of the unbundled network element platform, we believe we can continue to profitably provide competitive local exchange services as a result of a contractual arrangement entered into in January 2005 with the incumbent provider for switching services and leased lines. Our contracted rates ranged from \$17.46 to \$18.99 per line per month during 2005. Beginning January 1, 2006, the range for our rates increased to \$17.71 to \$20.02 per line per month. We intend to consider installing owned communications equipment in a community only after we have achieved sufficient scale and we believe such investment can be cost effective.

ITC began operations in February 2002. IT Communications began operations in January 2006 in Iowa City, Iowa and has since expanded to Ames and Cedar Rapids, Iowa. As of December 31, 2006, the CLEC served approximately 9,100 business and 14,700 residential access lines and currently accounts for 9% of Iowa Telecom's total access lines. The cost to expand our competitive local exchange carrier operations is predominantly comprised of variable expenses such as marketing and sales expenses, which allows us to more

Table of Contents

readily control the level of cash flow required to support expansion of this business and provides the opportunity to lower spending levels if necessary. In 2007, we plan to maintain this limited investment approach as we continue to grow our competitive local exchange carrier business.

Sales and Marketing

We have established a sales and marketing organization that centralizes marketing strategies and deploys sales and customer services resources locally. We have a dedicated sales force for business customers and have 19 local offices at which customers can contact us in person to address their needs.

We believe that customers in rural communities are concerned that historically they have had access to less sophisticated telecommunications products and services than consumers in urban locations. We believe these concerns have increased in recent years as advanced telecommunications services, such as readily available broadband Internet access, have come to be seen as essential to economic growth. We believe that residential and business end-users will be more likely to increase the use of our products and services if we are perceived as a locally managed provider, committed to delivering advanced telecommunications services to the communities we serve.

To address our customers' needs, we have established in-state support operations, including 19 customer offices and three customer contact centers. These customer offices and contact centers provide us with a significant degree of customer contact, thereby affording us an opportunity to offer and sell additional and enhanced services to our subscribers. In addition, we have created a community relations department whose purpose is to maintain an ongoing relationship with community leaders and organizations throughout our service area, with a view to developing Iowa Telecom's brand identity as a responsive, locally oriented provider. We believe this reputation also enhances our potential to cross-sell additional services to our existing subscriber base.

We also offer local telephone services in attractively priced bundled packages including long distance, enhanced local services, dial-up and DSL Internet access services and video services. We believe bundled services are popular with customers because they permit the purchase of a number of services at a discount to the pricing that would be available on an individual service basis. We intend to continue to expand this marketing strategy, which we expect will increase average revenue per access line. We also believe that integrated packages of quality services result in a more loyal and satisfied customer base, thereby reducing subscriber turnover.

Competition

Local Service. We currently face measurable competition from other providers of local services in approximately 44 of the 418 communities our incumbent local exchange carrier serves. We believe that in approximately 36 of these communities, independent local exchange carriers operating in adjacent exchanges and municipal utilities have constructed networks to provide competitive local exchange carrier services to customers in our exchanges. In other communities, competitive local exchange carriers are reselling our services or using their own facilities in combination with ours to provide telecommunications services. We estimate that our largest competitive local exchange carrier competitor serves approximately 9,300 lines in six of the exchanges in which we are the incumbent local exchange carrier. We estimate that our second largest competitive local exchange carrier competitor serves approximately 3,600 lines in three of the exchanges in which we are the incumbent local exchange carrier, and that our remaining competitive local exchange carrier competitors (none of which serve more than four exchanges in which we are the incumbent local exchange carrier) serve an average of fewer than 500 lines per exchange.

MCC Telephony of Iowa, Inc., the telecommunications affiliate of Mediacom, the dominant cable television provider in Iowa, is certificated to provide competitive local telecommunications service in approximately 100 Iowa Telecom exchanges. MCC's stated business plan is to use Sprint Communications Company L.P. ("Sprint") as an intermediary in interconnecting with incumbent local exchange carriers throughout Iowa, including Iowa

Table of Contents

Telecom, while MCC would retain the retail customer relationship. MCC has already entered the Des Moines market, but has yet to provide traditional wireline local exchange services in non-Qwest markets in Iowa, which we believe is at least partially due to the timing of MCC or Sprint obtaining and implementing agreements with us and certain other incumbent carriers. MCC's ability to enter non-Qwest markets in Iowa, including Iowa Telecom's, without its own interconnection agreement with such incumbent carriers remains a contested issue in federal court, although, for the time being, Iowa Telecom and certain other incumbent carriers are subject to Iowa Utilities Board-approved interconnection agreements with Sprint. Further, Iowa Telecom is subject to an Iowa Utilities Board order, also currently on appeal in federal court, requiring us to provide certain interconnection services pursuant to these interconnection agreements. Iowa Telecom is required to provide certain interconnection services while these appeals are pending. We cannot predict the outcome of the pending appeals.

In November 2004, an organization called "Opportunity Iowa" was formed to encourage municipalities to build their own "fiber-to-the-home" communications networks. Opportunity Iowa referendums were held in the November 2005 general election cycle in seven Iowa Telecom exchanges and were rejected by voters in all seven. We cannot predict whether Opportunity Iowa or similar initiatives will lead to additional future competition from municipal telecommunications utilities.

Wireless and Emerging Technology Competition. We estimate that wireless service providers served approximately 1.82 million subscribers in Iowa as of June 2006, based on the most recent FCC data available. We expect that wireless providers will continue to provide services that compete with ours. Technological developments in cellular telephone features, personal communications services, telephone services over cable television systems, satellite, voice over Internet protocol, high-speed fiber optic networks and other technologies will continue to provide our customers with alternatives to the traditional local telephone services we provide.

Iowa Communications Network. The Iowa Communications Network is a state-owned communications network consisting of more than 3,000 miles of fiber optic cable extending into all 99 Iowa counties and capable of providing a variety of voice, data and video communications services. The Iowa Communications Network currently provides certain voice, data and video communications services to authorized educational and governmental institutions, including accredited public and private schools and colleges, public libraries, state and federal agencies and the United States Post Office, and to authorized hospitals and physician clinics. Current state law does not allow the Iowa Communications Network to provide its services to other public or private entities and prohibits the sale, lease, or other disposition of the Iowa Communications Network without prior authorization of a majority of each house of the Iowa legislature and approval by the governor. The Iowa legislature has previously considered modifying state law to allow for sale of the Iowa Communications Network to a private party but has not done so.

Our Competitive Local Exchange Carrier Subsidiaries. We have two competitive local exchange carrier subsidiaries—ITC and IT Communications. The CLEC provides services in 21 of Qwest's Iowa exchanges. ITC generally offers the same local exchange services as those offered by Qwest and provides DSL Internet access service in all exchanges in which it operates, using either Qwest's wholesale service or owned facilities. IT Communications was formed in late 2005 to focus on larger markets in Iowa, and now serves Iowa City, Ames and Cedar Rapids.

Long Distance. We face significant competition in the long distance market. The FCC lists approximately 500 interexchange (toll) carriers in Iowa, a substantial number of which are, or are affiliated with, providers of local exchange services in Iowa. AT&T, Sprint, and MCI currently are the other major long distance providers in our service territory. We believe that wireless service also competes with the traditional wireline long distance service that we provide. Although the long distance market is competitive, we believe we are in a good position relative to our competitors given our local presence, strong brand and ability to offer both long distance and local services in a single bill. Approximately 58% of our local access lines also subscribe to one of our long distance services.

Table of Contents

Dial-up and DSL Internet Access. In many markets we face competition from other dial-up and broadband Internet access service providers. Many dial-up competitors are neighboring incumbent local exchange carriers, small proprietors with service in only a few communities or, in some circumstances near larger Iowa communities, national providers such as America Online and the Microsoft Network. In some of our markets, broadband competition exists from cable television providers (principally Mediacom Communications), wireless broadband providers using non-licensed spectrum and competitive local exchange carriers that either have their own facilities or have collocated DSL equipment in our central offices. We believe our ability to sell dial-up or broadband services on a bundled basis with local and long distance service enhances our competitive position for continued growth in sales of dial-up and DSL Internet access service.

Customers

Our incumbent local exchange carrier currently operates 288 local telephone exchanges in 418 largely rural communities. Our business is largely concentrated in the eastern and southern portions of Iowa. According to the 2000 U.S. Census, our service area includes four communities with a population over 9,000; ten communities with a population between 5,001 and 9,000; 25 communities with a population between 2,000 and 5,000; and 379 communities with a population under 2,000. The largest five communities in our service area in Iowa are (2000 population figures in parentheses): Newton (15,579); Pella (9,832); Fairfield (9,509); Grinnell (9,105); and Mount Pleasant (8,751). These five communities represent approximately 14% of the access lines we serve.

Approximately 75% of our incumbent local exchange carrier access lines serve residential customers. We also provide services to several large businesses in our service area, including, Pella Corporation (headquartered in Pella) and Vermeer Manufacturing Company (also headquartered in Pella). In addition, Grinnell and Pella are each home to a four-year university, namely Grinnell College and Central College. No single local service customer represented more than 5% of our revenues from 2004 to 2006.

As a competitive local exchange carrier, we currently operate in 21 local telephone exchanges which provide service to 24 communities with an aggregate population of 525,000. According to the 2000 U.S. Census, our CLEC service area includes fifteen communities with a population over 10,000, eight communities with a population between 5,001 and 10,000, and one community with a population below 5,000. The largest five communities served by the CLEC are (2000 population figures in parentheses): Cedar Rapids (120,758); Iowa City (62,220); Ames (50,731); Clinton (27,772); and Ankeny (27,117). These five communities represent approximately 20% of the total access lines in our competitive local exchange carrier markets. Approximately 62% of the access lines in our competitive local exchange carrier markets serve residential customers.

Network access charges historically have been one of our largest sources of revenues. Of the carriers paying these charges, AT&T is our single largest customer and represented approximately 11% of our revenue in 2006 and 12% in 2005, while no other customer has accounted for more than 10% of our revenue during the past three years.

Network Facilities

All of our exchanges are served by digital switches that we own, the majority of which were manufactured by Nortel Networks. All of our switches are capable of providing one-plus equal access for long distance service and are linked through a combination of aerial, underground and buried cable, including more than 3,100 miles of fiber optic cable. Most of our primary network routes have been upgraded from copper to fiber optic cable. The advantages of fiber optic cable compared to copper facilities are greater capacity and flexibility and enhanced transmission quality and reliability. Our network operations and monitoring services are provided on a contract basis by Iowa Network Services, Inc., which also provides those services for its own network and for other local exchange carriers in Iowa. Automated alarm systems are in place to alert us to problems with our facilities, and our own technicians are on call to make any necessary repairs to the network.

Table of Contents

The network facility upgrades we have completed since the GTE Midwest Incorporated acquisition in June 2000 include the following:

- we have deployed DSL Internet access service to all 288 exchanges, including those of Montezuma Mutual Telephone Company. We believe approximately 75% of our access lines are now DSL eligible.
- we have built a widespread data network to support our dial-up and DSL Internet access services customers.
- we have migrated most of the interexchange communications traffic originating from or terminating to our switches onto our own network facilities, reducing costs paid to third parties and increasing our network access charge revenues.
- we have reduced the number of access lines utilizing analog carrier technology from approximately 4,600 to approximately 950. Analog carrier lines are not fully compatible with advanced telephone services such as high-speed Internet.
- we have deployed voice-mail services to additional exchanges and are now able to offer voice-mail services to 259 exchanges and approximately 211,000 customers.

Our network improvement plan for 2005 through 2007 became effective on January 30, 2005. The additional revenues made available by the settlement of our rate proceeding in April 2004 will help fund our network improvement plans and will allow us to accelerate the rate at which we deploy DSL and other broadband services, replace analog carrier technology, upgrade switching platforms, install fiber, and otherwise support and deploy new voice and data services.

Employees

We employ approximately 644 full-time employees, of which 638 are based in Iowa and 6 are based in Nebraska. A total of approximately 363 employees are located at our headquarters in Newton, Iowa and our operations center in Grinnell, Iowa.

We have a collective bargaining agreement with the Communications Workers of America, or CWA, which covers approximately 184 of our employees and expires in May 2007. We also have a collective bargaining agreement with the International Brotherhood of Electrical Workers, or IBEW, which covers approximately 24 of our employees and expires in June 2009. There have been no work stoppages or strikes by our IBEW or CWA employees in the past 10 years, and we consider our labor relations to be good.

Intellectual Property

We believe we have the trademarks, trade names and licenses that are necessary for the operation of our business as we currently conduct it. The Iowa Telecom logo is a registered trademark in the United States. We do not consider our trademarks, trade names or licenses to be material to the operation of our business.

Regulation

The following summary does not describe all present and proposed federal, state and local legislation and regulations affecting us or the telecommunications industry. Some laws and regulations are currently the subject of judicial proceedings, legislative hearings and administrative proceedings that could change the manner in which our company or our industry operates. We cannot predict the outcome of any of these developments or their potential impact on us. Regulation can change rapidly in the telecommunications industry, and such changes may adversely affect us in the future. Our business is subject to extensive regulation that could change in a manner adverse to us.

Overview

We are subject to federal, state and local government regulation. We hold various authorizations for our service offerings. At the federal level, the FCC has jurisdiction over common carriers, such as us, to the extent

Table of Contents

that their facilities are used to originate, terminate or provide interstate and international telecommunications services. The Iowa Utilities Board exercises jurisdiction over our intrastate telecommunications services within Iowa. The Missouri Public Service Commission exercises similar jurisdiction over the intrastate telecommunications services we provide to a small number of customers in Missouri. In addition, under the Telecommunications Act of 1996, or the Telecom Act, federal and state regulators share responsibility for regulating such matters as interconnection between carriers. Municipalities and other local government agencies regulate certain aspects of our business, such as our use of public rights-of-way, and by requiring that we obtain construction permits and comply with building codes.

The following description discusses some of the major telecommunications-related regulations that affect us, but numerous other substantive areas of regulation not discussed here may influence our business. When we refer to "our incumbent local exchange carrier," we mean Iowa Telecommunications Services, Inc., and, when we refer to "our independent local exchange carrier," we mean our incumbent local exchange carrier operations other than those of Iowa Telecommunications Services, Inc. – i.e., Montezuma Mutual Telephone Company. When we refer to "our competitive local exchange carriers," we mean our Iowa Telecom Communications, Inc. and IT Communications, LLC subsidiaries.

Federal Regulation

We are subject to, and must comply with, the federal Communications Act of 1934, as amended by, among other things, the Telecom Act (the "Communications Act"). Under the Communications Act, we must obtain FCC approval before we transfer control of our company, assign, acquire, or transfer licenses or authorizations issued by the FCC or before we discontinue our interstate service in any area.

Access Charges. The FCC regulates the prices that incumbent local exchange carriers charge for the use of their local networks in originating or terminating interstate and international transmissions. State regulatory commissions, such as the Iowa Utilities Board, regulate prices for access provided in connection with the origination and termination of intrastate transmissions. The prices that we and other incumbent local exchange carriers charge for use of local telephone networks to complete interexchange calls—access services—are called "access charges."

We provide two types of access services, special access and switched access. The rates for special access, which is provided via dedicated circuits connecting long distance carriers, other carriers and certain end users to our network, are structured as flat-rate monthly charges. Rates for switched access are structured as a combination of flat-rate monthly charges, which are paid by end users, and per-minute traffic sensitive charges, which are paid by long distance carriers. A significant amount of our revenues come from access charges derived from intrastate, interstate and international transmissions.

Since 1991, the FCC has administered a system of price cap regulation for interstate access charges applicable to the largest incumbent local exchange carriers, as well as for any other, smaller incumbent local exchange carriers that choose to be subject to price cap regulation. Our incumbent local exchange carrier has operated under the price cap regime since July 2000 as a result of our acquiring GTE Midwest Incorporated's Iowa exchanges and succeeding to GTE's obligations to price its access charges in accordance with price cap regulation. We believe our incumbent local exchange carrier is the smallest carrier in the nation operating under the FCC's price cap rules.

Since July 1, 2000, our incumbent local exchange carrier's interstate access charges have been established in accordance with an order adopted by the FCC in response to a proposal put forth by members of The Coalition for Affordable Local and Long Distance Service ("CALLS Order"). The CALLS Order reformed access charge regulation for carriers subject to price caps. It implemented a system for reducing per-minute traffic sensitive rates for switched access services to specific target levels that the FCC believed more closely approximated the cost of providing those services. We met the target rates for switched access in our access charge filings made

Table of Contents

with the FCC in July 2001. In September 2003, the FCC permitted our incumbent local exchange carrier to increase our rates for switched access to more closely reflect our forward-looking economic costs.

The CALLS Order also permitted us to recover a greater proportion of our local costs by increasing the subscriber line charge levied on end users. In June 2002, the FCC adopted an order that permitted all price cap-regulated carriers, including us, to increase subscriber line charges to their current levels.

Our incumbent local exchange carrier files tariffs for its interstate access charges with the FCC annually. Our 2006 filing became effective on July 1, 2006 without objection.

In addition to the access charge system, our incumbent local exchange carrier also is subject to the requirements of the Communications Act and the FCC that impose on local telecommunications carriers a duty to establish reciprocal compensation arrangements for the transport and termination of non-toll telecommunications between telecommunications carriers. See “—Interconnection with Local Telephone Companies and Access to Other Facilities.” Under these rules, the calling party’s carrier must compensate the called party’s carrier for costs associated with transporting and terminating the call. At present, we only charge interconnecting wireless carriers for the transport and termination of calls bound for our network as Iowa Utilities Board rules impose a “bill-and-keep” regime for local traffic transport and termination when exchanged traffic is at least roughly balanced, as is the case for exchanged wireline traffic.

In April 2001, the FCC released a Notice of Proposed Rulemaking to determine whether to adopt a unified regime that would apply to all of these intercarrier compensation arrangements; such a regime could be a successor to the five-year transitional access charge system established by the CALLS Order. We are currently a party to one of the major industry intercarrier compensation reform proposals under consideration by the FCC – the proposal known as the Missoula Plan, filed with the FCC on July 24, 2006. The FCC received comments on the Missoula Plan in December 2006 and February 2007. The outcome of the FCC’s proceedings is uncertain, but it could result in significant changes to the way in which we receive compensation from other carriers and our end users. At this time, we cannot predict whether the FCC or Congress will change the current system and, if so, whether and to what extent any changes will affect our incumbent local exchange carriers’ or our competitive local exchange carriers’ access charge revenues and other reciprocal compensation receipts and payments.

Our competitive local exchange carriers also charge for interstate access in accordance with FCC requirements. These rules allow us to set our competitive local exchange carriers’ rates at the current National Exchange Carrier Association rates for switched access, excluding the rate for carrier common line charges.

The Telecommunications Act of 1996. The Telecom Act, which amended the Communications Act, changed and will continue to change the regulatory and competitive landscape in which we operate. The most important of these changes are removing most legal barriers to market entry into local telephone services; requiring that incumbent local exchange carriers, such as our incumbent local exchange carrier, interconnect with competitors and offer unbundled network elements; establishing procedures for the Regional Bell Operating Companies to provide long distance services within their home regions; and creating greater opportunities for competitive providers, such as our competitive local exchange carriers, to compete with other incumbent local exchange carriers. Each of these changes is discussed below.

Removal of Entry Barriers. Following the passage of the Telecom Act, the level of competition in the local markets served by our incumbent local exchange carrier has increased and is expected to increase. See “Business—Competition.” The requirements of the Telecom Act also effectively remove or prevent legal barriers to market entry and thereby permit our competitive local exchange carriers to provide competitive local exchange service in areas in which we are not the incumbent provider.

Interconnection with Local Telephone Companies and Access to Other Facilities. The Telecom Act imposes several requirements on all local exchange carriers, including competitive local exchange carriers, with additional requirements imposed on incumbent local exchange carriers. These requirements are intended to

Table of Contents

promote competition in the local exchange market by, in part, ensuring that a carrier seeking interconnection will have access to the interconnecting carrier's network functionalities under reasonable rates, terms and conditions.

All local exchange carriers, including both our incumbent local exchange carrier and our competitive local exchange carriers, must comply with the following requirements:

- *Resale.* Local exchange carriers generally may not prohibit or place unreasonable restrictions on the resale of their local services at retail rates.
- *Telephone Number Portability.* Local exchange carriers must provide for telephone number portability, allowing a customer to keep the same telephone number even when switching service providers.
- *Dialing Parity.* Local exchange carriers must provide dialing parity, which allows customers to route their calls to another local service provider without having to dial special access codes.
- *Access to Rights-of-Way.* Local exchange carriers must provide access to their poles, ducts, conduits and rights-of-way on a reasonable, nondiscriminatory basis.
- *Reciprocal Compensation.* Each local exchange carrier on whose network a call originates must reasonably compensate each telecommunications carrier on whose network the call terminates.

Under the Telecom Act, all incumbent local exchange carriers, including our incumbent local exchange carrier, but excluding certain exempt "rural telephone companies," must comply with the following additional requirements:

- *Duty to Negotiate.* Negotiate in good faith with any carrier requesting interconnection.
- *Interconnection.* Provide interconnection for the transmission and routing of telecommunications at any technically feasible point in the network, equal to interconnection provided to an affiliate or other party, and on just, reasonable and nondiscriminatory rates, terms and conditions.
- *Unbundling of Network Elements.* Provide nondiscriminatory access to unbundled network elements or combinations of unbundled network elements at cost-based rates.
- *Resale.* Offer its retail local telephone services to resellers at a wholesale rate that is less than the retail rate charged to end users.
- *Notice of Changes.* Provide notice of changes in information needed for another carrier to transmit and route services using the incumbent local exchange carrier's facilities.
- *Collocation.* Provide physical collocation, which allows competitive local exchange carriers to install and maintain their own network termination equipment in incumbent local exchange carriers' central offices, or to obtain functionally equivalent forms of interconnection.

Our incumbent local exchange carrier is a "rural telephone company," as defined by the Communications Act. In 1997, however, the Iowa Utilities Board removed the rural telephone company exemption applicable to what were then GTE Midwest Incorporated's Iowa exchanges, which we later acquired. As a result, this exemption does not apply to our incumbent local exchange carrier.

The Telecom Act affords small local exchange carriers (those with less than two percent of the nation's access lines) the opportunity to petition the state regulatory agency for suspension or modification of any of the requirements imposed on local exchange carriers. In March 2004, we filed with the Iowa Utilities Board a request for permission to delay implementation of local number portability and thousand block number pooling in certain switch locations. On September 17, 2004, the Iowa Utilities Board extended the deadline for Iowa Telecom to complete its implementation of local number portability to December 31, 2007 and extended the deadline for Iowa Telecom to complete its implementation of thousand block number pooling to May 2008. Our incumbent local exchange carrier has not otherwise requested any suspension or modification of, and we believe we are otherwise in compliance with, all other interconnection requirements of the Telecom Act.

Table of Contents

As of December 31, 2006, our incumbent local exchange carrier had interconnection agreements with 36 of the competitive local exchange carriers authorized to offer local service in our service area, and 12 active interconnection agreements in force with wireless carriers. We are currently negotiating five additional interconnection agreements with wireline competitors.

Unbundling of Network Elements. To implement the interconnection requirements of the Telecom Act, incumbent local exchange carriers, including our incumbent local exchange carrier, are required to provide unbundled network elements to competitors based on forward-looking economic costs, using the total element long-run incremental cost, or TELRIC, methodology. Our incumbent local exchange carrier is in compliance with these requirements and is meeting its obligations to unbundle its network. Our competitive local exchange carriers entered some local markets where Qwest is the incumbent local exchange carrier by initially obtaining a combination of unbundled network elements, including unbundled switching and local loops (known as the unbundled network platform), from Qwest.

Under the FCC's current unbundled network element rules, which became effective March 11, 2005, an incumbent local exchange carrier's obligation to provide access to high capacity loops and dark fiber is eliminated immediately, and the obligation to provide access to unbundled switching and, by implication, to the unbundled network element platform will be phased-out over an 18-month period. The new rules, however, will continue to impose an obligation to provide unbundled access to DS-1 loops and certain forms of dedicated transport. These rules are currently subject to appeal. We are unable to predict what impact, if any, such proceedings may have on our incumbent local exchange carrier or on our competitive local exchange carriers.

In light of the phase-out of incumbent local exchange carrier obligations to provide access to the unbundled network element platform, we entered into arrangements with Qwest in which our CLECs will have continuing access to an equivalent Qwest product for current and new customers regardless of future FCC or judicial action regarding the availability of unbundled network elements. However, the rates we must pay under the agreements are somewhat higher than before we entered into the agreements. The agreements with Qwest expire in 2008.

The FCC is also examining its TELRIC pricing rules, which apply generally to all unbundled network elements. The FCC may, in the future, reconsider other aspects of its local competition rules. Congress may consider legislation that would affect local competition and these rules. We cannot predict the outcome of any of these proceedings, or of any action or decision taken by the FCC, the Iowa Utilities Board, any legislative body or court concerning the rules regarding local competition, and how any changes would affect either our incumbent local exchange carrier or our competitive local exchange carriers.

Bell Operating Company Entry into Long Distance Services. Qwest is our competitive local exchange carriers' principal competitor in regions in which Qwest is the incumbent local exchange carrier. Pursuant to provisions of the Telecom Act, in December 2002, the FCC authorized Qwest to provide in-region long distance services, a line of business from which Qwest was previously prohibited from entering. Now that Qwest, a Regional Bell Operating Company, is authorized to provide long distance services, it competes more directly with providers of integrated communications services, such as our competitive local exchange carriers.

Regulation of Interstate and International Services. The Communications Act requires that we offer interstate and international common carrier services at just and reasonable rates and on terms and conditions that are not unreasonably discriminatory. In general, our interstate and international long distance services are not subject to rate regulation but are subject to the FCC's complaint procedures. Pursuant to the FCC's rules, we disclose the terms and conditions of our long distance services on our web site.

Universal Service. Pursuant to Federal statute, the FCC maintains a "universal service" program, to ensure that affordable, quality telecommunications services are available to all Americans. The program at the federal level has several components, including one that pays support to "high cost" areas, including certain areas served by rural local exchange carriers for which the costs of providing basic telephone service are significantly higher

Table of Contents

than the national average. The Telecom Act altered the framework for providing and funding universal service by:

- requiring the FCC to make implicit subsidies explicit;
- expanding the types of telecommunications carriers that are required to pay universal service support; and
- allowing telecommunications carriers to apply to state regulators for, and be eligible for, universal service support, including where they serve customers formerly served by incumbent local exchange carriers.

These and other provisions were intended to make the provision of and contributions to universal service compatible with a competitive market.

Universal service funds are only available to carriers designated as eligible telecommunications carriers by the state regulatory commission. Although our incumbent local exchange carrier is certified as an eligible communications carrier by the Iowa Utilities Board with respect to the exchanges that we operate, under current FCC rules it is not eligible to receive any high-cost support because the historical cost of relevant portions of our network, largely based on the recorded amounts that transferred with our acquisition of exchanges from GTE Midwest Incorporated, are lower than the national average. Under the FCC's rules, support is available only for rural carriers with historical loop costs above the national average.

The CALLS Order also provided for a phase-out of implicit universal service support mechanisms (which had, in part, relied on setting rates for interstate access above cost), to be replaced with more explicit subsidy mechanisms. The CALLS Order created an Interstate Access Support fund as part of the Universal Service Fund to accomplish this objective. For 2006, our incumbent local exchange carrier received approximately \$3.3 million in universal service support from this portion of the fund.

Our competitive local exchange carriers serving 21 competitive local exchange carrier exchanges have been certified as eligible telecommunications carriers in Iowa by the Iowa Utilities Board. ITC receives no high-cost or Interstate Access Support for the Qwest markets it has entered because Qwest currently receives no high cost support and only nominal Interstate Switched Access Support for the exchanges served by ITC. Qwest receives no high cost support and no Interstate Switched Access Support for the three exchanges served by IT Communications, and therefore IT Communications receives no universal service support.

Our incumbent local exchange carrier and competitive local exchange carriers are required to make contributions to the federal universal service program based on methodologies and procedures established by the FCC. Contributions to the federal universal service fund are based on revenues from interstate and international services. In accordance with FCC rules, we recover our contributions from our customers through a surcharge on interstate and international revenues. The surcharge is adjusted each quarter and has increased in recent quarters. In 2006, our incumbent local exchange carrier and competitive local exchange carriers collected and contributed to the universal service fund approximately \$3.4 million and \$151,000, respectively. While suspensions of some universal service fund payments to schools and libraries pursuant to the Federal Anti-Deficiency Act in the Fall of 2004 were thought by industry experts to foreshadow potential related delays or suspensions of payments from other support programs administered by the Universal Service Administrative Company, perhaps including Interstate Access Support payments received by our incumbent local exchange carrier, Congress has prevented any suspensions of such payments through at least December 31, 2007. We cannot predict whether and for how long Interstate Access Support payments might be delayed or suspended or how actions to address this problem may affect us.

In 2000, the FCC implemented new rules requiring the high cost universal service support received by non-rural telephone companies to be based on forward-looking costs. In May 2001, the FCC adopted a proposal from the Rural Task Force to reform universal service support for rural areas. Although the rules adopted in

Table of Contents

response to the Rural Task Force proposal were to expire July 1, 2006, no replacement rules have been established, leaving the current regime temporarily in place. Under the currently-effective rules, eligible rural carriers will continue to receive support based on a modified embedded cost mechanism. The FCC has indicated that, upon replacement of the rules adopted in response to the Rural Task Force proposal, it will develop a comprehensive plan for high-cost support mechanisms for rural and non-rural carriers, which may rely on forward-looking cost estimates. The FCC referred these issues to the Federal-State Joint Board on Universal Service, which, in August 2004, requested comment on future federal universal service support mechanisms for rural carriers and, in August 2005, sought further comment on more detailed proposals. Some of these proposals include moving significantly more carriers (including mid-sized carriers such as our incumbent local exchange carrier) to support based on forward-looking cost. We do not expect the Joint Board to issue a recommendation until at least the second quarter of 2007, which would then likely be followed by FCC consideration of the Joint Board's recommendation.

Internet. We provide Internet access services as an Internet service provider ("ISP"). Historically, the FCC has regulated wireline carrier provision of broadband Internet service as comprising two components—a "telecommunications" component representing the transmission function that is subject to common carrier regulation, including contributing to the Universal Service Fund, and an "information service" component, which is not regulated (either with respect to price or the terms and conditions of service). The FCC concluded in an order effective November 16, 2005 that wireline carrier provision of broadband Internet access service comprises only "information service" and does not include a regulated telecommunications component. Therefore, pursuant to a regulatory election by our incumbent local exchange carrier, effective November 16, 2005, all portions of our DSL service are now deregulated and detariffed, which provides us with enhanced pricing flexibility. However, wireline carriers must continue to contribute to the universal service fund. The FCC order that became effective on November 16, 2005 is currently subject to appeal. We cannot predict the outcome of these proceedings or the effect of FCC or judicial decisions on our ISP, incumbent local exchange carrier or competitive local exchange carrier businesses. Our ISP business is, and may become, subject to a variety of other legal requirements relating to privacy, copyrights, the conveyance of obscenity, indecent speech, unsolicited electronic messages and taxation.

In February 2004, the FCC determined that a particular type of entirely Internet-based voice over Internet protocol service also is an information service and exempt from such regulatory obligations, and in November 2004 determined that another, more widely used, version of voice over Internet protocol service is an interstate service and therefore outside the jurisdiction of state telecommunications regulations. Certain aspects of the FCC's determination have been challenged in judicial proceedings. The FCC is currently considering the regulatory status of a variety of voice over Internet protocol service configurations in the context of a comprehensive proceeding launched in February 2004, as well as in several other application and issue-specific proceedings. These proceedings concern, among other things, what, if any, intercarrier compensation must be paid by providers of such service and what, if any, universal service contributions must be made by such providers. We cannot predict the outcome of these proceedings or the effect of FCC or judicial decisions on any of our ISP, incumbent local exchange carrier or competitive local exchange carrier businesses.

Customer Information. Companies such as our incumbent local exchange carrier and competitive local exchange carriers are subject to statutory and regulatory limitations on the use of customer information we acquire by virtue of providing telecommunications services, including information related to the quantity, technical configuration, type, destination and amount of a customer's use of services. Under these rules, we may not use such information acquired through one of our service offerings to market other service offerings without the approval of the affected customers. We believe that we are in compliance with these obligations, which may affect our incumbent local exchange carrier's ability to market some services to our customers. On February 10, 2006, the FCC adopted a notice of proposed rulemaking seeking comment on potential additional measures regarding carrier protection of customer data. We cannot predict the outcome of these proceedings or the effect of FCC or judicial decisions on our incumbent local exchange carrier or competitive local exchange carrier businesses.

Table of Contents

Communications Assistance for Law Enforcement Act. Under the Communications Assistance for Law Enforcement Act ("CALEA") and related federal statutes, we are required to provide law enforcement officials with call content and call identifying information under a valid electronic surveillance warrant and to reserve a sufficient number of circuits for use by law enforcement officials in executing court-authorized electronic surveillance. We believe we are in compliance with the laws and regulations, as currently applied. On September 23, 2005, the FCC released an order determining that facilities-based broadband providers and providers of interconnected voice over Internet Protocol ("VoIP") services must be prepared to accommodate law enforcement wiretaps pursuant to the "CALEA" by May 14, 2007. On May 12, 2006, the FCC released a follow-up order further detailing compliance obligations, although uncertainty remains regarding technical aspects of such compliance. We cannot predict whether and when the FCC might modify such regulations or any other rules, or what compliance with new rules might cost.

Preferred Carrier Selection Changes. A customer may change his or her preferred long distance carrier at any time, but the FCC and the Iowa Utilities Board regulate this process and require that specific procedures be followed. The FCC and Iowa Utilities Board have levied substantial fines for unauthorized changes and have recently increased the penalties for such conduct. We believe we are in compliance with the required processes and procedures, and no such fines have been assessed against us.

Service Outage Reporting. On August 4, 2004, the FCC adopted rules requiring certain telecommunications carriers to begin reporting additional information to the FCC in the event of selected service outages and related events affecting some fiber rings. On December 20, 2004, the FCC stayed the rules' effectiveness pending agency reconsideration of their merits, in part due to concerns about the substantial expenditures required of telecommunications carriers in order to comply with the new reporting obligations. At this time, we cannot predict the consequences of the FCC's reconsideration or the financial or operational impacts any final rules may have on us.

Regulation of Our Independent Incumbent Local Exchange Carrier. Our independent incumbent local exchange carrier, Montezuma Telephone, which for regulatory purposes is treated as independent of our incumbent local exchange carrier, is generally subject to the same federal regulation as our incumbent local exchange carrier, with certain exceptions. First, Montezuma Telephone continues to maintain the rural exemption from certain interconnection obligations. Second, Montezuma Telephone's interstate access charges are subject to historical investment-based rate regulation applicable to non-price-cap carriers. Montezuma Telephone, in particular, falls into the category of non-price-cap carriers known as "average schedule" companies, whose historic costs are simulated through formulae, individual company data and pooled data. Montezuma Telephone, through a management agreement with Iowa Wireless Services, LLC ("Iowa Wireless"), provides commercial mobile radio (mobile wireless) service in its incumbent local exchange carrier service territory and is subject to provisions of the Communications Act and FCC rules concerning wireless carriers. Montezuma Telephone also provides cable television service in Montezuma, Deep River, and Barnes City, an activity also subject to provisions of the Communications Act and FCC rules. Neither Montezuma Telephone's mobile wireless nor cable television service are subject to federal rate regulation. Just as we are unable to predict the outcome of pending and potential proceedings affecting the federal regulation of our incumbent local exchange carrier, we are unable to predict the outcome of such proceedings, such as intercarrier compensation reform, on our independent incumbent local exchange carrier subsidiary.

Regulation Applicable to our Advanced Wireless Service Licenses

We currently hold 15 FCC Advanced Wireless Services licenses in Iowa. Our ownership of these licenses subjects us to FCC regulation of the wireless services we may choose to provide and the technical operating characteristics of the network equipment we may utilize. In addition, our rights to renew these licenses at the end of their initial 15-year terms will depend, at least in part, on our compliance with build-out requirements promulgated by the FCC. We cannot predict changes that may occur in the FCC's regulation of our Advanced Wireless Services licenses, the network we may build or the services we may provide over the period of time we may hold the licenses.

Table of Contents*Environmental Regulation*

We are subject to federal, state and local laws and regulations governing the use, storage, disposal of, and exposure to, hazardous materials, the release of pollutants into the environment and the remediation of contamination. As an owner or operator of property and a generator of hazardous wastes, we could be subject to certain environmental laws that impose liability for the entire cost of cleanup at a contaminated site, regardless of fault or the lawfulness of the activity that resulted in contamination. We believe, however, that our operations are in substantial compliance with applicable environmental laws and regulations.

In 2004 we discovered that groundwater near the underground diesel fuel storage tank located at our Mount Pleasant, Iowa facility contained levels of Total Extractable Hydrocarbons ("TEH") for diesel and waste oil that exceeded the Tier 1 target levels established by the Iowa Department of Natural Resources. Subsequent testing has confirmed the presence of diesel and waste oil TEH and also revealed the presence of free diesel product. As a result of a Tier 2 evaluation and free product assessment conducted in 2005, the site has been assigned a "No Action Required" classification by the Iowa Department of Natural Resources. We continue, however, to maintain a monitoring well and expect to do so until groundwater samples reveal essentially no free diesel product for 24 months. We do not believe that any expense relating to the Mount Pleasant underground storage tank will result in a material adverse effect on our financial condition.

State Regulation

Incumbent Local Exchange Carrier. The Iowa Utilities Board is responsible for regulating the rates, terms and conditions pursuant to which our incumbent local exchange carrier provides basic intrastate local telephone service and switched access service for intrastate transmissions within Iowa. The Iowa Utilities Board also has jurisdiction over the service quality of the incumbent local exchange carrier's intrastate services and relationships with our customers. As required by the Iowa Utilities Board, our incumbent local exchange carrier files and receives approval of tariffs for local telephone and switched access service. These tariff filings are available on our web site. The Iowa Utilities Board does not regulate the rates our incumbent local exchange carrier charges for other services, including intrastate long distance, intrastate special access, directory assistance, voicemail and local private line services, or for services provided to multi-line business customers.

The Iowa Utilities Board has granted a certificate of public convenience and necessity to our incumbent local exchange carrier to provide local telephone service in Iowa. We may not transfer our certificate, transfer control of our company or discontinue providing local services in any of the exchanges we serve without first obtaining the Iowa Utilities Board's approval. The Iowa Utilities Board has the power to penalize us or revoke our certificate if we are in material violation of any law or regulation. We also must obtain the Iowa Utilities Board's approval to acquire the whole or any substantial part of the assets or the controlling capital stock of any public utility in Iowa, or to sell or otherwise dispose of the whole or any substantial part of our assets. In addition, the Iowa Utilities Board is responsible for implementing some of the state and federal laws and regulations intended to promote competition. It also has authority under the Telecom Act to establish the rates and terms on which competitive local exchange carriers can interconnect with and obtain unbundled access to incumbent local exchange carrier networks.

The jurisdiction of the Iowa Utilities Board over our local retail rates changed dramatically as a result of state deregulatory legislation that became effective on July 1, 2005. Pursuant to this legislation, each telephone utility then subject to rate regulation, such as Iowa Telecom, was permitted to elect to deregulate its charges for all of its retail business and residential local exchange services except single line flat-rated residential and business service and Extended Area Services, which will remain rate regulated until at least June 30, 2008. We exercised this option effective July 1, 2005. For services that remain rate-regulated, monthly rates may be adjusted annually by one dollar for residential lines and two dollars for business lines, plus an inflation increment, up to a monthly rate cap of \$19.00 for residential lines and \$38.00 for business lines. Pursuant to a January 25, 2007 interpretation by the Iowa Utilities Board, the \$19.00 and \$38.00 limits are inclusive of any

Table of Contents

incremental inflationary adjustments and, therefore, once met, do not permit further inflationary adjustments. Upon request by a utility, however, rates may be modified by the Iowa Utilities Board to reflect exogenous factors beyond the control of the utility. These rates do not include charges for Extended Area Services, which, to the extent that it is offered in conjunction with single line flat-rate service, remains regulated by the Iowa Utilities Board. Single line flat-rated business and residential service and EAS will also be deregulated as of July 1, 2008 unless the Iowa Utilities Board determines that the public interest requires it to extend its jurisdiction over such services to July 1, 2010. If the Iowa Utilities Board decides to continue price regulation to 2010, both residential and business monthly rates may be increased up to two dollars during each twelve-month period of the extension and the overall rate caps of \$19.00 and \$38.00 will be eliminated.

Pursuant to Iowa Telecom's election, all retail offerings other than single line flat-rate residential and business service (and associated Extended Area Services), such as calling features, second residential lines, Centrex, and bundled packages, were deregulated effective July 1, 2005.

Our intrastate switched access rates continue to be rate-regulated as they were prior to July 1, 2005 – capped at the level set in 1998. The prohibition on changes in our incumbent local exchange carrier's intrastate access charges did not apply to the intrastate carrier common line rate, which the Iowa Utilities Board set at \$0.03 per intrastate minute of use.

In April 2004, our incumbent local exchange carrier reached a settlement agreement with the Iowa Utilities Board and other parties. Pursuant to the settlement agreement, we are obligated to invest substantially all additional revenues generated by the allowed increase in our rates, except for revenues resulting from inflation adjustments, on capital improvements identified in our network improvement plan. This investment is in addition to our baseline level of network capital expenditures, which was assumed to be \$16 million per year during the initial period of the plan. The initial period continued until we had spent \$38.9 million of cumulative capital expenditures in excess of our assumed baseline investment level. This requirement was satisfied in 2006. Beginning in 2007, both the baseline and the incremental investment levels will increase or decrease consistent with access line changes and further deregulation. We expect that a minimum annual capital investment of approximately \$18 million will satisfy the ongoing commitments.

The new law that became effective July 1, 2005 also gives the Iowa Utilities Board jurisdiction to entertain a complaint by certain local exchange carriers that other carriers have engaged in activity that is inconsistent with the antitrust laws and the policies underlying them, and allows the Iowa Utilities Board to punish such behavior by adjusting retail rates in an amount sufficient to correct the antitrust activity, ordering the local exchange carrier engaging in such activity to pay costs incurred by the complainant in pursuing the complaint, imposing civil penalties against the local exchange carrier engaging in such activity, and ordering either the complainant or the other local exchange carrier to pay the costs of the complaint proceeding including the other party's reasonable attorney fees.

Iowa law authorizes the Iowa Utilities Board to deregulate communications services or facilities if the Iowa Utilities Board determines a service or facility is subject to effective competition. On December 23, 2004, the Iowa Utilities Board issued an order deregulating all rates charged by Iowa Telecom for local exchange service in 14 Iowa Telecom exchanges in which we face facilities-based competition. We began to offer local exchange service at deregulated rates in these deregulated exchanges later in 2005. In addition, on December 5, 2005, the Iowa Utilities Board deregulated an additional 14 exchanges where we face facilities-based competition.

Competitive Local Exchange Carriers. We have two competitive local exchange carrier subsidiaries—ITC and IT Communications. The CLEC provides services in 21 of Qwest's Iowa exchanges. ITC generally offers the same local exchange services as those offered by Qwest, using unbundled network facilities provided by Qwest pursuant to our agreement with them, and provides DSL Internet access service in all the exchanges in which it operates, using either Qwest's wholesale service or owned facilities. IT Communications began operations in January 2006. IT Communications operates similarly to ITC, but is focused on larger markets in Iowa, presently

Table of Contents

Iowa City, Cedar Rapids and Ames. The Iowa Utilities Board does not have jurisdiction over the rates for local basic communications service of our competitive local exchange carriers, but our competitive local exchange carriers do file tariffs regarding the terms and conditions for such service with the Iowa Utilities Board.

The Iowa Utilities Board has jurisdiction over our competitive local exchange carriers' switched access rates. The Iowa Utilities Board rules allow our competitive local exchange carriers to adopt the tariffs of any other carrier providing switched access service in Iowa. Our competitive local exchange carriers, like a majority of competitive local exchange carriers in the state, have adopted the switched access rates contained in the access tariff of the Iowa Telecommunications Association. The Iowa Utilities Board also has jurisdiction over the service quality of our competitive local exchange carriers' intrastate services and relationships with their customers.

Independent Incumbent Local Exchange Carrier. As a provider of fewer than 15,000 access lines, our independent incumbent local exchange carrier, Montezuma Telephone, is not subject to the retail and access rate regulation of the Iowa Utilities Board, although it is subject to the Board's complaint jurisdiction regarding intrastate access rates. Neither Montezuma Telephone's mobile wireless nor cable television service is subject to state rate regulation. Montezuma Telephone provides cable television service pursuant to franchise agreements with the cities of Barnes City, Deep River and Montezuma which include certain operational requirements.

Other

Our incumbent local exchange carrier provides local exchange services from three exchanges in Iowa that include approximately 100 access lines that serve customers physically located in Missouri. With regard to these access lines, our incumbent local exchange carrier is subject to the jurisdiction of the Missouri Public Service Commission, which is responsible for granting operating certificates to local service providers and regulating the intrastate access service, local service, the service quality and relationships with customers of incumbent local exchange carriers operating in Missouri. Our incumbent local exchange carrier is certified to operate in Missouri and, as such, has approved tariffs on file with the Missouri Public Service Commission. Our incumbent local exchange carrier contributes to the Missouri universal service fund and also files service quality and financial monitoring reports with the Missouri Public Service Commission on an annual and quarterly basis.

Neither the Iowa Utilities Board nor the Missouri Public Service Commission regulates dial-up Internet access or high-speed Internet access services to customers of either our incumbent local exchange carrier or our competitive local exchange carriers.

Local Government Authorizations

In some communities, our incumbent local exchange carrier is required to obtain certain authorizations from municipal authorities, such as permits, licenses or easements to install and maintain the facilities and equipment necessary to provide telecommunications services. We believe we are in compliance with all such requirements. Some jurisdictions where we may provide service may require license or franchise fees based on criteria established by Iowa statute. These amounts are not material to our incumbent local exchange carrier operations.

To the extent our competitive local exchange carriers provide service through facilities or services purchased from Qwest, no local government authorizations are required. If our competitive local exchange carriers were to construct their own facilities, they may be subject to the requirements of local governments in such markets. Currently, our competitive local exchange carriers pay no local license or franchise fees.

Table of Contents**ITEM 1A. Risk Factors**

Set forth below are risks and uncertainties that could cause actual future results to differ materially from those described herein.

Risk Related to Our Capital Structure and Ownership

Our dividend policy may limit our ability to pursue growth opportunities.

Our board of directors adopted a dividend policy, effective upon closing of our initial public offering in November 2004, which reflects an intention to distribute a substantial portion of the cash generated by our business in excess of operating needs, interest and principal payments on our indebtedness and capital expenditures as regular quarterly dividends to our shareholders. As a result, we may not retain a sufficient amount of cash to finance a material expansion of our business, or to fund our operations consistent with past levels of funding in the event of a significant business downturn. In addition, because a significant portion of cash available to pay dividends will be distributed to holders of our common stock under our dividend policy, our ability to pursue any material expansion of our business, including through acquisitions or increased capital spending, will depend more than it otherwise would on our ability to obtain third party financing. We cannot assure you that such financing will be available to us at all, or at an acceptable cost.

You may not receive any dividends.

We are not obligated to pay dividends. Dividend payments are not guaranteed and are within the absolute discretion of our board of directors. Future dividends with respect to shares of our common stock, if any, will depend on, among other things, our results of operations, working capital requirements, financial condition, contractual restrictions, business opportunities, anticipated cash needs, provisions of applicable law and other factors that our board of directors may deem relevant. In addition, we have reported a loss from continuing operations in the past.

We might not generate sufficient cash from operations in the future to pay dividends on our common stock in the intended amounts or at all. Our board of directors may decide not to pay dividends at any time and for any reason. Our dividend policy is based upon our directors' current assessment of our business and the environment in which we operate, and that assessment could change based on competitive or technological developments (which could, for example, increase our need for capital expenditures), new growth opportunities or other factors. If our cash flows from operations for future periods were to fall below our minimum expectations, we would need either to reduce or eliminate dividends or, to the extent permitted under the terms of our credit facilities, fund a portion of our dividends with borrowings or from other sources. If we were to use working capital or permanent borrowings to fund dividends, we would have less cash and/or borrowing capacity available for future dividends and other purposes, which could negatively affect our financial condition, our results of operations, our liquidity and our ability to maintain or expand our business. Our board is free to depart from or change our dividend policy at any time and could do so, for example, if it were to determine that we had insufficient cash to take advantage of growth opportunities. In addition, our credit facilities contain limitations on our ability to pay dividends. See "Dividend Policy and Restrictions" in Item 5 of this report. The reduction or elimination of dividends may negatively affect the market price of our common stock.

We have substantial indebtedness and may incur additional indebtedness in the future, which could restrict our ability to pay dividends.

Our ability to make distributions, pay dividends or make other payments will be subject to applicable law and contractual restrictions contained in the instruments governing any indebtedness of ours and our subsidiaries, including our credit facilities. The degree to which we are leveraged on a consolidated basis could have important consequences to the holders of our common stock, including the following:

- our ability in the future to obtain additional financing for working capital, capital expenditures or acquisitions may be limited;

Table of Contents

- a significant portion of our cash flow from operations is likely to be dedicated to the payment of the principal of and interest on our indebtedness, thereby reducing funds available for future operations, capital expenditures and/or dividends on our common stock;
- we may be more vulnerable to economic downturns and be limited in our ability to withstand competitive pressures; and
- we may have limited flexibility to plan for and react to changes in our business or strategy.

In addition, we may incur substantial additional indebtedness in the future. Any additional debt incurred by us could increase the risks associated with our substantial leverage.

We are subject to restrictive debt covenants and other requirements related to our outstanding debt that limit our business flexibility by imposing operating and financial restrictions on us.

Covenants in the credit facilities impose significant operating and financial restrictions on us. These restrictions prohibit or limit, among other things:

- the incurrence of additional indebtedness and the issuance of preferred stock and certain redeemable capital stock;
- the payment of dividends on, and purchase or redemption of, capital stock;
- a number of other restricted payments, including investments and acquisitions;
- specified sales of assets;
- specified transactions with affiliates;
- the creation of a number of liens on our assets;
- consolidations, mergers and transfers of all or substantially all of our assets;
- our ability to change the nature of our business; and
- our ability to make capital expenditures.

These restrictions could limit our ability to obtain future financing, make acquisitions or fund capital expenditures, withstand downturns in our business or take advantage of business opportunities. Furthermore, the credit facilities also require us to maintain specified total leverage and fixed charge coverage ratios and satisfy specified financial condition tests, and may require us to make annual mandatory prepayments with a portion of our available cash. See "Long-Term Debt and Revolving Credit Facilities" in Item 7 of this report. Our ability to comply with the ratios or tests may be affected by events beyond our control, including prevailing economic, financial and industry conditions.

A breach of any of these covenants, ratios or tests could result in a default under the credit facilities. Upon the occurrence of an event of default under the credit facilities, the lenders could elect to declare all amounts outstanding under the credit facilities to be immediately due and payable. If the lenders accelerate the payment of the indebtedness under the credit facilities, our assets may not be sufficient to repay in full this indebtedness and our other indebtedness.

We may not be able to refinance our credit facilities at maturity on favorable terms or at all.

Our credit facilities will mature in full in 2011. We may not be able to renew or refinance the credit facilities, or any renewal or refinancing may occur on less favorable terms. If we were unable to refinance or renew our credit facilities, our failure to repay all amounts due on the maturity date would cause a default under the credit facilities. In addition, our interest expense may increase significantly if we refinance our credit

Table of Contents

facilities on terms that are less favorable to us than the terms of our existing credit facilities, which could impair our ability to pay dividends.

We will require a significant amount of cash, which may not be available to us, to service our debt, pay dividends and fund our other liquidity needs.

Our ability to make payments on, or to refinance or repay, our debt, to fund planned capital expenditures, to pay dividends and to expand our business will depend largely upon our future operating performance. Our future operating performance is subject to general economic, financial, competitive, legislative and regulatory factors, as well as other factors that are beyond our control. Our business may not generate enough cash flow, or future borrowings may not be available to us under the credit facilities or otherwise, in an amount sufficient to enable us to pay our debt, pay dividends or fund our other liquidity needs. If we are unable to generate sufficient cash to service our debt requirements, we will be required to refinance our credit facilities. We may not be able to refinance any of our debt, including the credit facilities, under such circumstances on commercially reasonable terms or at all. If we were unable to refinance our debt or obtain new financing under these circumstances, we would have to consider other options, including:

- sales of certain assets to meet our debt service requirements;
- sales of equity; and
- negotiations with our lenders to restructure the applicable debt.

Our credit facilities could restrict our ability to do some of these things. If we are forced to pursue any of the above options under distressed conditions, our business and/or the value of our common stock could be adversely affected.

There may be volatility in the trading price of our common stock, which could negatively affect the value of an investment in our common stock.

The market price of our common stock may fluctuate widely as a result of various factors, such as period-to-period fluctuations in our operating results, sales of our common stock by significant shareholders, developments in the telecommunications industry, the failure of securities analysts to cover our common stock or changes in financial estimates or opinions by analysts, competitive factors, regulatory developments, economic and other external factors, interest rates, general market conditions and market conditions affecting the stock of telecommunications companies in particular. Telecommunications companies have in the past experienced extreme volatility in the trading prices and volumes of their securities, which has often been unrelated to operating performance. Any such market volatility may have a significant adverse effect on the market price of our common stock.

Future sales, or the possibility of future sales, of a substantial amount of our common stock may depress the price of the shares of our common stock.

Future sales, or the availability for sale in the public market, of substantial amounts of our common stock could adversely affect the prevailing market price of our common stock, and could impair our ability to raise capital through future sales of equity securities.

Certain investors that held shares of our common stock prior to our initial public offering in November 2004, continue to hold 943,907 shares of common stock as of December 31, 2006. These shares are eligible for resale pursuant to Rule 144(k) under the Securities Act. In addition, members of our management and other employees hold fully vested options to purchase a total of 682,579 shares of our common stock as of December 31, 2006, all of which have been registered under the Securities Act of 1933 and may be exercised and sold at any time.

Table of Contents

We may issue shares of our common stock, or other securities, from time to time as consideration for future acquisitions and investments. In the event any such acquisition or investment is significant, the number of shares of our common stock, or the number or aggregate principal amount, as the case may be, of other securities that we may issue may in turn be significant. We may also register, or grant registration rights covering, those shares or other securities in connection with any such acquisitions and investments.

Your interests may conflict with those of our current shareholders with whom we conduct significant business.

One of our shareholders that held shares of our common stock prior to our initial public offering, Iowa Network Services, Inc., as of December 31, 2006 held approximately 3.0% of our outstanding common stock through one of its subsidiaries, Pine Island Capital Corporation. Iowa Network Services, Inc. is in the telecommunications business and provides long distance, wireless, dial-up and DSL Internet access and other services throughout Iowa that compete with certain aspects of our business to the extent permitted by the terms of non-competition arrangements between Iowa Network Services, Inc. and us. We anticipate that Iowa Network Services, Inc. will continue to compete with us in the future, and such competition may intensify following any reduction in Iowa Network Services, Inc.'s equity interest in us.

Iowa Network Services, Inc. is owned by approximately 127 independent incumbent local exchange carriers, which we believe each own less than 5% of Iowa Network Services, Inc. These incumbent local exchange carriers provide telecommunications services in exchanges adjacent to or nearby our exchanges, sometimes in competition with services we provide. Competition with these incumbent local exchange carriers could intensify following any reduction in Iowa Network Services, Inc.'s equity interest in us.

Our organizational documents could limit another party's ability to acquire us and therefore could deprive our investors of the opportunity to obtain a takeover premium for their shares.

A number of provisions in our articles of incorporation and bylaws will make it difficult for another company to acquire us and, therefore, for investors to receive any related takeover premium for their shares. For example, our articles of incorporation provide for a classified board of directors, prohibit removal of directors without cause and authorize the issuance of preferred stock without shareholder approval and upon such terms as the board of directors may determine. The rights of the holders of shares of our common stock will be subject to, and may be adversely affected by, the rights of holders of any class or series of preferred stock that may be issued in the future.

We are also subject to laws that may have a similar effect. For example, federal and Iowa telecommunications laws and regulations generally prohibit a direct or indirect transfer of control over our business without prior regulatory approval. Section 490.1110 of the Iowa Business Corporation Act prohibits us from engaging in a business combination with an interested shareholder for a period of three years from the date the person became an interested shareholder unless certain conditions are met. The Iowa Business Corporation Act also provides that only shareholders representing at least 50% of our shares entitled to vote may request that our board of directors call a special meeting of shareholders and that, in evaluating any acquisition offer, our board of directors may consider the interests of our employees, suppliers, creditors and customers, the interests of the communities in which we operate, and the long-term interests of our company and the shareholders, in addition to the financial interests of shareholders.

Limitations on usage of our net operating losses, and other factors requiring us to pay cash taxes in future periods, may affect our ability to pay dividends to you.

Our initial public offering resulted in an "ownership change" for purposes of Section 382 of the Internal Revenue Code. As a result, our ability to use our substantial net operating losses to offset taxable income for taxable periods ending after the date of the offering are limited. In addition, we currently are able to take deductions of approximately \$40.0 million from taxable income associated with the amortization of intangibles

Table of Contents

through 2014. Consequently, in the future we may be required to pay cash income taxes because of limitations on using our net operating losses, or because all of our net operating losses have been used or have expired, or because our intangible assets have been fully amortized. Any of the foregoing would have the effect of increasing our taxable income and potentially reducing our after-tax cash flow available for payment of dividends in future periods, and may require us to reduce dividend payments on our common stock in such future periods.

Risks Relating to Our Business and Industry

Competition in the telecommunications industry could result in access line losses or reduce our customer base, possibly requiring that we lower our rates, increase marketing expenditures, invest in new technologies or capabilities or use discounting and promotional campaigns that adversely affect our margins.

We face actual or potential competition from other telecommunications service providers, including wireless service providers, who have entered and may continue to enter our service areas. Such competition has resulted in access line losses. In general, when we lose a customer to a competitor for local service we also lose that customer for all related services, such as long distance and Internet service, and may also lose the access charge revenues for that customer. We have interconnection agreements with 36 of the competitive local exchange carriers authorized to offer local service in our service area, of which four are authorized to provide service statewide and 32 are authorized to provide service only in specific exchanges or regions.

In addition, six municipal telephone utilities operate as competitive local exchange carriers in some of our markets, and other communities we serve may in the future evaluate the establishment of a municipal telephone utility. In particular, in November 2004, an organization called "Opportunity Iowa" was formed to encourage municipalities to build their own fiber to the home communications networks. Opportunity Iowa referendum votes were held in the November 2005 general election cycle in seven Iowa Telecom exchanges. The Opportunity Iowa referendums were defeated in all seven communities. We cannot predict the likelihood of further competition from municipal telecommunications utilities on our business.

MCC Telephony of Iowa, Inc., the telecommunications affiliate of Mediacom, the dominant cable television provider in Iowa, is certificated to provide competitive local telecommunications service in approximately 100 Iowa Telecom exchanges. MCC's stated business plan is to use Sprint Communications Company L.P. ("Sprint") as an intermediary in interconnecting with incumbent local exchange carriers throughout Iowa, including Iowa Telecom, while MCC would retain the retail customer relationship. MCC has already entered the Des Moines market, but has yet to provide traditional wireline local exchange services in non-Qwest markets in Iowa, which we believe is at least partially due to the timing of MCC or Sprint obtaining and implementing agreements with us and certain other incumbent carriers. MCC's ability to enter non-Qwest markets in Iowa, including Iowa Telecom's service area, without its own interconnection agreement with incumbent carriers remains a contested issue in federal court, although, for the time being, Iowa Telecom and certain other incumbent carriers are subject to Iowa Utilities Board-approved interconnection agreements with Sprint. Further, Iowa Telecom is subject to an Iowa Utilities Board order, also currently on appeal in federal court, requiring us to provide certain interconnection services pursuant to these interconnection agreements. Iowa Telecom is required to provide certain interconnection services while these appeals are pending. We cannot predict the outcome of the pending appeals.

Wireless providers also currently compete in most of our rural markets. We expect this competition to continue, and likely become more acute, in the future. We also compete, or may in the future compete, with companies that provide other close substitutes for the traditional telephone services we provide, like cable television, voice over Internet protocol, high-speed fiber optic networks or satellite telecommunications services, and companies that might provide traditional telephone services over nontraditional network infrastructures, like electric utilities. We are subject to regulations, like those requiring us to provide number portability for wireless carriers, that reduce the barriers to entry faced by some providers of substitute services, and may be subject to other regulations favoring substitute services in the future.

Table of Contents

We may continue to lose access lines due to economic conditions and competition.

Our business generates revenue by delivering voice and data services over access lines. In the past, we have experienced net access line loss due to challenging economic conditions and increased competition. Our total access line count decreased by 3.1% during 2005, and 2.6% during 2006. Access lines decreased 5.5% for 2005, and 4.1% for 2006, if we exclude lines served by our competitive local exchange carrier. We may continue to experience net access line losses in our markets for an unforeseen period of time. Continued access line losses could adversely affect our revenues and earnings.

We may in the future compete with the Iowa Communications Network or with a future purchaser of the assets now owned by the Iowa Communications Network.

The Iowa Communications Network, a state-owned limited use network with more than 3,000 miles of fiber optic cable extending into all 99 Iowa counties, and capable of providing a variety of voice, data and video communication services, currently is prohibited by state law from providing telephone service to parties other than school districts, higher education institutions, state and federal agencies, the United States Post Office, hospitals and physicians' clinics and public libraries. The assets now owned by the Iowa Communications Network could be used to provide voice, data and video communications, and the state of Iowa has previously considered modifying state law to remove some of the usage restrictions applicable to the Iowa Communications Network or permit the sale of the Iowa Communications Network to a private party. A sale of the Iowa Communications Network or its assets, or a change in the law permitting broader use of the Iowa Communications Network, could provide additional competition for us.

We may not be able to integrate future technologies, respond effectively to customer requirements or provide new services.

The communications industry is subject to rapid and significant changes in technology, frequent new service introductions and evolving industry standards. We cannot predict the effect of these technological changes on our business. New technologies and products may not be compatible with our existing technologies and systems. In addition, our existing technologies and systems may not be competitive with new superior technologies and products, which may reduce service prices. These developments could require us to incur unbudgeted upgrades or to procure additional products that could be expensive. If we do not adequately replace or upgrade our technology and equipment that becomes obsolete, we may not be able to compete effectively. Technological changes in the communications industry may have a material adverse effect on our business or financial results. We may not be able to obtain timely access to new technology on satisfactory terms or incorporate new technology into our systems in a cost effective manner, or at all.

In addition to technological advances, other factors could require us to further expand or adapt our network, including an increasing number of customers, demand for greater data transmission capacity, failure of our technology and equipment to support operating results anticipated in our business plan and changes in our customers' service requirements. Expanding or adapting our network could require substantial additional financial, operational and managerial resources, any of which may not be available to us.

Network disruptions could adversely affect our operating results.

To be successful, we will need to continue providing our customers with a high capacity, reliable and secure network. Some of the risks to our network and infrastructure include:

- physical damage to access lines, central offices, central office equipment, or equipment used in our underlying voice and data networks;
- power loss from, among other things, adverse weather conditions;
- capacity limitations;

Table of Contents

- software and hardware defects and malfunctions;
- breaches of security, including sabotage, tampering, computer viruses and break-ins; and
- other disruptions that are beyond our control.

Disruptions or system failures may cause interruptions in service or reduced capacity for customers. If service is not restored in a timely manner, agreements with our customers or service standards set by the Iowa Utilities Board may obligate us to provide credits or other remedies, and this would reduce our revenues or increase our costs. Service disruptions could also damage our reputation with customers, causing us to lose existing customers or have difficulty attracting new ones.

We may not be able to maintain the necessary rights-of-way for our network.

We are dependent on rights-of-way and other permits from railroads, utilities, state highway authorities, local governments and transit authorities to install conduit and related telecommunications equipment for any expansion of our network. We may need to renew current rights-of-way for our network and cannot assure you that we would be successful in renewing these agreements on acceptable terms. Some of our agreements may be short-term, revocable at will, or subject to termination upon customary default provisions, and we may not have access to existing rights-of-way after they have expired or terminated. If any of these agreements were terminated or could not be renewed, we may be required to remove our existing facilities from under the streets or abandon our networks. Similarly, we may not be able to obtain right-of-way agreements on favorable terms, or at all, in new service areas, and, if we are unable to do so, our ability to expand our network, if we decide to do so, could be impaired.

The successful operation and growth of our business are dependent on economic conditions and population stability in Iowa.

Virtually all of our customers and operations are located in Iowa. Due to our geographical concentration, the successful operation and growth of our businesses is dependent on economic conditions in Iowa. The Iowa economy, in turn, is dependent upon many factors, including the strength of the agricultural economy and continued growth in manufacturing and service industries.

The economies of rural communities, such as those that we serve, are affected by many of the same factors as the Iowa economy in general. In addition, rural communities face additional challenges to their economic stability and growth. The populations of many rural communities in Iowa, particularly smaller towns, have been declining. Limited capital availability may hinder the growth of rural businesses. Any deterioration in general economic conditions in Iowa is likely to result in lower demand for our services, which would reduce our revenues.

Our competitive local exchange carrier strategy may adversely affect our profitability and Adjusted EBITDA.

We intend to expand our operations in both telephone and Internet services through our two competitive local exchange carrier subsidiaries into areas adjacent to our incumbent local exchange carrier territory. As of December 31, 2006, we had approximately 23,800 competitive local exchange carrier access lines in 21 exchanges. We expanded into additional markets and have a net investment of approximately \$1.1 million in our competitive local exchange carrier operations cumulative through December 31, 2006, principally to fund operating losses during this expansion phase. Our competitive local exchange carrier business incurred losses through most of this expansion period and may require additional funding for capital expenditures and potential operating losses in the future. Competitive local exchange carrier profitability is contingent on obtaining customers from the incumbent local exchange service provider in a cost-effective manner. Either an incumbent provider or another competitive local exchange carrier may diminish our profitability by expanding its marketing efforts or offering additional products. Furthermore, as a result of the recently enacted statutory provisions

Table of Contents

regarding deregulation of basic local services, the incumbent provider will have greater flexibility to respond to competition from our competitive local exchange carriers, which may reduce our margins and have other negative impacts on our profitability.

We face risks associated with our strategy of growth through acquisitions.

Any future acquisitions will depend on our ability to identify suitable acquisition candidates, negotiate acceptable terms for their acquisition and finance those acquisitions. In addition, future acquisitions by us could result in the incurrence of indebtedness or contingent liabilities, which could have a material adverse effect on our business and our ability to achieve sufficient cash flow, provide adequate working capital and service our indebtedness. Any future acquisitions could also expose us to increased risks, including:

- the difficulty of integrating the acquired personnel, network, operations and other support systems;
- the potential disruption of our ongoing business and diversion of resources and management time;
- the inability to generate revenues from acquired businesses sufficient to offset acquisition costs;
- the inability of management to maintain uniform standards, controls, procedures and policies;
- the risks of entering markets in which we have little or no direct prior experience;
- the difficulty in enhancing our customer support resources to adequately service our existing customers and acquired customers; and
- the impairment of relationships with suppliers, employees, or unions as a result of changes in management of the acquired company.

Any future acquisitions of access lines will likely be subject to prior approvals from the Federal Communications Commission and the Iowa Utilities Board or other applicable state regulatory commissions. We may not be able to obtain such approvals, in which case the acquisition could be delayed or not consummated.

We may not be successful in efficiently managing the growth of our business.

Our business plan will, if successfully implemented, result in growth of our operations, which may place a significant strain on our management, financial and other resources. To achieve and sustain growth we must, among other things, monitor operations, control costs, maintain regulatory compliance, maintain effective quality controls and maintain adequate internal management, technical, provisioning, information, billing, customer service and accounting systems. We may not be able to successfully integrate and use the employee, management, operational and financial resources necessary to manage a developing and expanding business in an evolving, regulated and increasingly competitive industry.

Our relationships with other telecommunications companies are material to our operations and their financial difficulties may affect our business.

We originate and terminate calls for long distance carriers and other interexchange carriers over our network and for that service we receive payments called access charges. Some of the carriers that pay us these access charges are our largest customers in terms of revenues. Several such carriers have declared bankruptcy in recent years, and others are experiencing substantial financial difficulties. Our inability to collect access charges from these bankrupt or financially distressed carriers has had a negative effect on our financial results and cash flows, as would any subsequent bankruptcies or disruptions in the businesses of these or other interexchange carriers. Our ability to collect past due amounts of access billings from carriers is hampered by federal and state regulations governing business relationships of these bankrupt or financially distressed carriers.

We use many vendors and suppliers that derive significant amounts of business from customers in the telecommunications business. Associated with the difficulties facing many service providers, some of these

Table of Contents

vendors and suppliers recently have experienced substantial financial difficulties, in some cases leading to bankruptcies and liquidations. Any disruptions experienced by these vendors and suppliers as a result of their own financial difficulties may affect their ability to deliver products or services to us, and delays in such deliveries could have an adverse affect on our business.

We face risks associated with our reliance on our information and billing systems.

We currently rely on a combination of internal systems and licenses with third party vendors for our information and billing systems. These systems are vital to our growth and our ability to monitor and control costs, bill customers, process orders, and provide customer service. If our information and billing systems fail or do not perform as expected, our ability to collect revenues, provide adequate customer service and accurately track our expenses and revenues would be impaired, with potentially materially adverse effects on our business and operations. In addition, if our third party vendors cancel or do not renew our license agreements, we could face disruption in our operations, as well as unforeseen expense for obtaining suitable replacement services from other vendors.

Labor disputes with our employees could interrupt our operations and adversely affect our business.

We have a collective bargaining agreement with the Communications Workers of America, or CWA, which covers approximately 184 of our employees and expires in May 2007. We also have a collective bargaining agreement with the International Brotherhood of Electrical Workers, or IBEW, which covers approximately 24 of our employees and expires in June 2009. If we negotiate acceptable terms with the CWA or IBEW at the expiration of the current agreement, our operating costs could increase as a result of higher wages or benefits paid to union members, and if we fail to reach an agreement with the unions our operations could be disrupted. Either event could have a material adverse effect on our business, results of operations or financial condition.

We depend on key members of our senior management team.

Our success depends largely on the skills, experience and performance of key members of our senior management team, including Alan L. Wells, our President, CEO and Chairman. Competition for senior management in our industry is intense, and we may have difficulty retaining our current managers or attracting new managers in the event of termination or resignation.

Risks Related to Our Regulatory Environment

Our business is subject to extensive regulation that could change in a manner adverse to us.

We operate in a heavily regulated industry, and most of our revenues come from providing services regulated by the Federal Communications Commission, or FCC, and the Iowa Utilities Board. Federal and state communications laws and regulations may be amended in the future, and other laws or regulations may be enacted which will affect our business. The FCC and the Iowa Utilities Board may add new rules, amend their rules or change the interpretation of their rules at any time. Laws and regulations applicable to us and our competitors may be, and have been, challenged in the courts, and could be changed at any time. We cannot predict future developments or changes to the regulatory environment, or the impact such developments or changes would have on us.

FCC and Iowa Utilities Board decisions concerning telecommunications policy and judicial review of such decisions may adversely affect our business.

The Telecom Act provides for significant changes and increased competition in the telecommunications industry. This federal statute and its related regulations remain subject to judicial review and additional rulemakings of the FCC, thus making it difficult to predict what effect this actually will have on us, our operations and our competitors. For example, as discussed in more detail under Regulation-Federal Regulation,

Table of Contents

the FCC is considering changes to intercarrier compensation applicable to local exchange carriers and wireless providers that could adversely affect the access revenues of our incumbent local exchange carrier and competitive local exchange carrier operations, and the manner in which we will be compensated for terminating calls originating on other carriers' networks and compensate other carriers for handling calls that originate on our network. The FCC is also examining its universal service policies, including policies with respect to both contribution and disbursement, that could have an effect on the amount and timing of our receipt of universal service funds. Further, many FCC telecommunications decisions are subject to substantial judicial review and delay. These delays and related litigation create uncertainty over federal policies and rules, and may affect our business plans, investments and operations. The Iowa Utilities Board establishes state telecommunications policy, particularly in the areas of discretionary deregulation, both on a service type and geographic basis, and the consequences thereof. Orders of the Iowa Utilities Board are also subject to judicial review.

New regulations and changes in existing regulations may force us to incur significant expenses.

Our business may be adversely affected by laws and regulations that impose new or greater obligations related to assisting in law enforcement, bolstering homeland security, reducing environmental impacts, or other aspects of our business. For example, existing provisions of the Communications Assistance for Law Enforcement Act and FCC regulations implementing the Communications Assistance for Law Enforcement Act require telecommunications carriers to ensure that their equipment, facilities, and services are able to facilitate authorized electronic surveillance. As discussed in Item 1 under "Regulation—Federal Regulation", the FCC has concluded that facilities-based broadband providers and providers of interconnected voice over Internet protocol services must be prepared to accommodate law enforcement wiretaps by May 14, 2007, although uncertainty remains regarding technical aspects of compliance. We cannot predict whether and when the FCC might modify such regulations or any other rules, or what compliance with new rules might cost. Similarly, we cannot predict whether or when federal or state legislators or regulators might impose new security, environmental or other obligations on our business. Such new obligations include FCC outage reporting obligations, stayed by the FCC on December 20, 2004, pending reconsideration, that may, if enacted, require substantial compliance expenditures.

As the incumbent local exchange carrier in our service areas, we are subject to regulation that is not applicable to our competitors.

Federal and state rules impose obligations and limitations on us, as an incumbent local exchange carrier, that are not imposed on some of our competitors. Federal obligations require us to, among other things, share facilities, allow unbundled access to our network and resale of our services purchased at wholesale rates, file tariffs for access charges, maintain certain types of accounts, and file certain types of reports. Similarly, Iowa law imposes, among other things, accounting and reporting requirements and service obligations on us that do not exist for our competitors. In addition, in Iowa we operate under a statutory price regulation plan that, with regard to our single line flat-rated retail local exchange services, imposes obligations and restrictions on us that are not generally imposed on our competitors. As our business becomes increasingly competitive, these regulatory disparities could impede our incumbent local exchange carrier business's ability to compete in the marketplace, which, in turn, could have a material adverse effect on our business.

Changes to existing regulations may reduce the revenue we receive from network access charges.

Access charges, which are intended to compensate us for providing other carriers with originating, terminating or transport services for their calls on our local network, accounted for approximately 41% of our revenues in 2006. Access charges are collected as fees charged to providers of long distance services, fees charged to business and residential customers, and fees charged to wireless providers and other local exchange carriers for originating and terminating their interexchange calls.

Large long distance providers have advocated in the past, and continue to advocate, that access charges they are required to pay should be reduced and the revenues replaced, perhaps only in part, by raising the fees charged

Table of Contents

to business and residential customers or by receipts from a universal service fund. Large long-haul network providers have also argued and continue to argue that access charges do not apply to specific types of traffic. The combined or individual results of these long distance carrier efforts could reduce the amount of access charge revenue we receive. Access charge reform is a key element of the universal service and intercarrier compensation issues under review by state and federal regulators and legislators. We cannot predict whether or when action may be taken on any of these issues, or what effect any action may have on revenues and costs of our incumbent local exchange carrier and competitive local exchange carrier operations.

To the extent that services that compete with ours are subject to different regulatory regimes, our revenues, particularly from network access charges, may be reduced.

The emerging technology known as voice over Internet protocol can be used to carry user-to-user voice communications over dial-up or broadband service. The FCC has determined that a particular type of entirely Internet-based voice over Internet protocol service also is an information service and exempt from such regulatory obligations, but that another, more widely-used, version of voice over Internet protocol service is an interstate service and therefore outside the jurisdiction of state telecommunications regulations. Certain aspects of the FCC's determination have been challenged in judicial proceedings. The FCC is currently considering the regulatory status of a variety of voice over Internet protocol service configurations in the context of a comprehensive proceeding launched in February 2004 as well as several more application and issue-specific proceedings. These proceedings concern, among other things, what, if any, intercarrier compensation must be paid by providers of such service and what, if any, universal service contributions such providers must make. Expanded use of voice over Internet protocol technology could reduce the access revenues received by local exchange carriers like us. We cannot predict the outcome of these proceedings or the effect of FCC or judicial decisions on any of our ISP, incumbent local exchange carrier or competitive local exchange carrier businesses.

Because we are subject to extensive laws and regulations relating to the protection of the environment, natural resources and worker health and safety, we may face significant liabilities or compliance costs in the future.

Our operations and properties are subject to federal, state and local laws and regulations relating to protection of the environment, natural resources and worker health and safety, including laws and regulations governing and creating liability relating to, the management, storage and disposal of hazardous materials, asbestos, petroleum products and other regulated materials. As a result, we face several risks, including the following:

- Under certain environmental laws, we could be held liable, jointly and severally and without regard to fault, for the costs of investigating and remediating any actual or threatened environmental contamination at currently and formerly owned or operated properties, and those of our predecessors, and for contamination associated with disposal by us or our predecessors of hazardous materials at third party disposal sites. Hazardous materials may have been released at certain current or formerly owned properties as a result of historic operations.
- The presence of contamination can adversely affect the value of our properties and our ability to sell any such affected property or to use it as collateral.
- We could be held responsible for third party property damage claims, personal injury claims or natural resource damage claims relating to any such contamination.
- The cost of complying with existing environmental requirements could be significant.
- Adoption of new environmental laws or regulations or changes in existing laws or regulations or their interpretations could result in significant compliance costs or as yet identified environmental liabilities.
- Future acquisitions of businesses or properties subject to environmental requirements or affected by environmental contamination could require us to incur substantial costs relating to such matters.

Table of Contents**ITEM 6. Selected Financial Data**

The following selected financial data for the years ended December 31, 2002 through 2006 has been derived from our consolidated financial statements. The following data should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" under Item 7 and our consolidated financial statements for 2004, 2005 and 2006 and the related notes thereto contained under Item 8. The figures in the table below reflect rounding adjustments.

	Iowa Telecommunications Services, Inc. and Subsidiaries				
	Year Ended December 31,				
	2002(a)	2003	2004(b)	2005	2006
	(in thousands, except per share data)				
Statement of Operations Data:					
Total revenues & sales	\$ 203,319	\$ 205,509	\$ 228,119	\$ 231,640	\$ 234,085
Operating costs & expenses:					
Cost of services & selling general and administrative expenses	85,500	83,775	93,184	105,826	108,670
Depreciation & amortization	43,919	45,849	47,941	48,600	47,736
Total operating costs & expenses	129,419	129,624	141,125	154,426	156,406
Operating income	73,900	75,885	86,994	77,214	77,679
Other Income (expense):					
Interest and dividend income	2,724	4,034	4,057	1,078	953
Interest expense	(53,982)	(51,838)	(55,654)	(31,089)	(31,708)
Other, net	—	—	(21,193)	(813)	(572)
Total other expense, net	(51,258)	(47,804)	(72,790)	(30,824)	(31,327)
Income before income taxes	22,642	28,081	14,204	46,390	46,352
Income tax expense	—	—	—	—	12,309
Income before cumulative effect of a change in accounting principle	22,642	28,081	14,204	46,390	34,043
Cumulative effect of a change in accounting principle	(98,369)	—	—	—	—
Net income (loss)	(75,727)	28,081	14,204	46,390	34,043
Gain on redemption of redeemable convertible preferred stock	—	—	57,681	—	—
Preferred dividend	(8,750)	(8,750)	(2,056)	—	—
Income (loss) available for common stockholders	\$ (84,477)	\$ 19,331	\$ 69,829	\$ 46,390	\$ 34,043
Per Share Data:					
Income before cumulative effect of a change in accounting principle:					
Basic	\$ 0.61	\$ 0.86	\$ 2.97	\$ 1.50	\$ 1.09
Diluted	\$ 0.61	\$ 0.79	\$ 2.64	\$ 1.46	\$ 1.06
Net income (loss) per share:					
Basic	\$ (3.74)	\$ 0.86	\$ 2.97	\$ 1.50	\$ 1.09
Diluted	\$ (3.74)	\$ 0.79	\$ 2.64	\$ 1.46	\$ 1.06
Cash dividends declared	\$ —	\$ —	\$ 0.175	\$ 1.62	\$ 1.62

Table of ContentsIowa Telecommunications Services, Inc.
and Subsidiaries
Year Ended December 31,

	2002(a)	2003	2004(b)	2005	2006
	(in thousands, except per share data)				
Balance Sheet Data (at end of period):					
Cash & cash equivalents	\$ 13,499	\$ 36,849	\$ 2,874	\$ 26,782	\$ 13,613
Property plant and equipment, net	361,813	341,515	331,736	315,499	298,975
Total assets	927,657	931,738	852,784	864,522	859,529
Long-term senior debt	677,375	645,750	477,778	477,778	477,778
Redeemable convertible preferred stock	125,000	125,000	—	—	—
Shareholders' equity	57,344	76,675	275,962	280,531	267,699
Cash Flow Data:					
Net cash provided by operating activities	\$ 69,957	\$ 79,780	\$ 76,635	\$ 97,321	\$ 89,493
Net cash provided by (used in) investing activities	(15,922)	(24,805)	5,722	(30,235)	(44,423)
Net cash used in financing activities	(41,625)	(31,625)	(116,332)	(43,178)	(58,239)
Other Financial Data:					
Adjusted EBITDA(c)	\$ 118,556	\$ 124,683	\$ 137,935	\$ 127,864	\$ 124,317
Interest expense	53,982	51,838	55,654	31,089	31,708
Capital expenditures	19,408	23,761	34,803	30,141	28,122

- (a) Effective January 1, 2002, we adopted Statement of Financial Accounting Standards, or SFAS, "No. 142, Accounting for Goodwill and Other Intangible Assets", ("SFAS No. 142") which provides that goodwill and other intangible assets with indefinite lives shall not be amortized and shall be tested for impairment of value on an annual basis. In connection with the adoption of SFAS No. 142, we recorded an impairment of goodwill of \$98.4 million, based on an independent appraisal, as a cumulative effect of change in accounting principle as of January 1, 2002.
- (b) Includes the recognition, as a result of our rate settlement agreement with the Iowa Utilities Board in April 2004, of \$7.1 million of revenues that we had collected in prior periods subject to refund pending such agreement. In addition, Other, net includes \$22.4 million of costs associated with our initial public offering and related debt refinancing.
- (c) We present Adjusted EBITDA because we believe it is a useful indicator of our historical debt capacity and our ability to service debt and pay dividends. We also present Adjusted EBITDA because covenants in our credit facilities contain ratios based on Adjusted EBITDA.

Adjusted EBITDA is defined in our credit facilities as: (1) consolidated net income, as defined therein; plus (2) the following items, to the extent deducted from consolidated net income: (a) interest expense; (b) provision for income taxes; (c) depreciation and amortization; (d) transaction expenses related to our initial public offering and the related debt refinancing and other limited expenses related to permitted securities offerings, investments and acquisitions incurred after the closing date of the our initial public offering, to the extent not exceeding \$5.0 million; (e) unrealized losses on financial derivatives recognized in accordance with SFAS No. 133; (f) non-cash stock-based compensation expense; (g) extraordinary or unusual losses (including extraordinary or unusual losses on permitted sales of assets and casualty events); (h) losses on sales of assets other than in the ordinary course of business; and (i) all other non-cash charges that represent an accrual for which no cash is expected to be paid in the next twelve months; minus (3) the following items, to the extent any of them increases consolidated net income: (w) extraordinary or unusual gains (including extraordinary or unusual gains on permitted sales of assets and casualty events); (x) gains on asset disposals not in the ordinary course; (y) unrealized gains on financial derivatives recognized in accordance with SFAS No. 133; and (z) all other non-cash income (including the non-cash portion of any RTFC patronage capital allocation). If our Adjusted EBITDA were to decline below certain levels, covenants in our new credit facilities that are based on Adjusted EBITDA, including our fixed charge coverage and total leverage ratio covenants, may be violated and could cause, among other things, a default or mandatory prepayment under our credit facilities, or result in our inability to pay dividends.

Table of Contents

We believe that net income is the most directly comparable financial measure to Adjusted EBITDA under generally accepted accounting principles. Adjusted EBITDA should not be considered in isolation or as a substitute for consolidated statement of operations and cash flows data prepared in accordance with GAAP. Adjusted EBITDA is not a complete measure of an entity's profitability because it does not include costs and expenses identified above; nor is Adjusted EBITDA a complete net cash flow measure because it does not include reductions for cash payments for an entity's obligation to service its debt, fund its working capital, make capital expenditures and make acquisitions or pay its income taxes and dividends.

The following table sets forth a reconciliation of Net Income (Loss) to Adjusted EBITDA:

	Iowa Telecommunications Services, Inc. and Subsidiaries				
	Year Ended December 31,				
	2002(1)	2003	2004(2)	2005	2006
	(in thousands, except per share data)				
Net Income (Loss)	\$ (75,727)	\$ 28,081	\$ 14,204	\$ 46,390	\$ 34,043
Income tax expense	—	—	—	—	12,309
Interest expense	53,982	51,838	55,654	31,089	31,708
Depreciation and amortization	43,919	45,849	47,941	48,600	47,736
Unrealized (gains) losses on financial derivatives	—	—	(1,452)	234	572
Non-cash stock-based compensation expense	—	—	141	1,828	2,354
Extraordinary or unusual (gains) losses	—	—	—	—	—
Non-cash portion of RTFC Capital Allocation	(773)	(1,085)	(1,142)	(277)	(211)
Other non-cash losses (gains)	98,369	—	—	—	—
Loss (gain) on disposal of assets not in ordinary course	(1,214)	—	—	—	(4,194)
Transaction costs	—	—	22,589(3)	—	—
Adjusted EBITDA	<u>\$ 118,556</u>	<u>\$ 124,683</u>	<u>\$ 137,935</u>	<u>\$ 127,864</u>	<u>\$ 124,317</u>

- (1) Effective January 1, 2002, we adopted Statement of Financial Accounting Standards, or SFAS, No. 142, which provides that goodwill and other intangible assets with indefinite lives shall not be amortized and shall be tested for impairment of value on an annual basis. In connection with the adoption of SFAS No. 142, we recorded an impairment of goodwill of \$98.4 million, based on an independent appraisal, as a cumulative effect of change in accounting principle as of January 1, 2002.
- (2) Includes the recognition, as a result of our rate settlement agreement with the Iowa Utilities Board in April 2004, of \$7.1 million of revenues that we had collected in prior periods subject to refund pending such agreement.
- (3) Transaction costs related to our initial public offering and the related debt refinancing. Includes \$22.4 million reflected in Other, Net and \$148,000 reflected in Operating Expense on the Consolidated Statement of Operations.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis should be read in combination with the selected financial data and the consolidated financial statements and notes thereto included in Items 6 and 8 herein.

Overview**General**

We are the largest provider of wireline local exchange telecommunications services to residential and business customers in rural Iowa, serving over 440 communities across the state. We are the second-largest local exchange carrier in Iowa. Iowa Telecom currently operates 288 telephone exchanges as the incumbent or "historical" local exchange carrier and is the sole telecommunications company providing wireline services in approximately 85% of those exchanges. Together with our competitive local exchange carrier subsidiaries, we provide services to approximately 252,000 access lines in Iowa.

Our core businesses are the provision of local telephone service and network access to other telecommunications carriers for calls originated or terminated on our network. In addition to these core activities, which generated 74% of our total revenues in 2006, we provide long distance service, dial-up and DSL Internet access and other communications services. As part of our strategy of pursuing growth beyond our current service area, we compete for customers in adjacent markets in Iowa through our competitive local exchange carrier subsidiaries, Iowa Telecom Communications, Inc. ("ITC") and IT Communications, LLC ("IT Communications"). Together, ITC and IT Communications are referred to as the "CLEC" or our "CLEC Operations".

Factors Affecting Our Operating Performance

We believe that a number of industry and Company-specific factors have affected and will continue to affect our results of operations. These factors include the following:

- the effect on our revenues of declining numbers of access lines resulting from competition and other factors and our strategic response to this trend, which includes efforts to introduce enhanced local services and additional services like dial-up and DSL Internet access and long distance service and to cross-sell these services to our subscriber base;
- the effect on our revenues of our rate and pricing structure, including recent and potential future changes in rate regulation at the state and federal levels;
- the continuing effects of the implementation of 2004 and 2005 Iowa Utilities Board orders deregulating retail local service rates in 28 exchanges and the statewide election we made effective July 1, 2005;
- our ability to control our variable operating expenses, such as sales and marketing expense; and
- the development of our competitive local exchange carrier strategy.

Access Line Trends

The number of access lines served is a factor that can affect a telecommunications provider's revenues. Consistent with a general trend in the rural local exchange carrier industry in the past few years, the number of access lines we serve as an incumbent local exchange carrier has been gradually decreasing. We expect that this trend will continue. Because substantially all of our revenues result from our relationships with customers who utilize our access lines and the level of activity recorded on those lines, the access line trend has an adverse impact on our revenues. Our response to this trend will have an important impact on our future revenues. Our primary strategy to respond to this trend is to leverage our strong incumbent market position to increase our revenue per access line by selling additional services to our customer base and to promote our DSL Internet access service offering, which is often used in lieu of additional access lines devoted to Internet usage. In

Table of Contents

addition, we expect to add new access lines as we pursue expansion of our service area through our competitive local exchange carrier subsidiaries and, potentially, through selected acquisitions of other telecommunications companies or lines from other telecommunications companies. However, we believe that the number of access lines served is not the sole meaningful indicator of our operating prospects and that, given our relatively stable subscriber base and ability to offer additional services, average revenue per access line is also a meaningful indicator for us.

The table below indicates the total number of access lines we serve and the number of customers subscribing to the indicated types of service as of the dates and for the periods shown:

	As of and for the Year Ended		
	December 31,		
	2004	2005	2006
Incumbent local exchange access lines(1)	251,800	237,900	228,200
Competitive local exchange carrier access lines(2)	15,200	20,800	23,800
Total access lines	267,000	258,700	252,000
Long distance subscribers	135,800	142,800	146,600
Dial-up Internet subscribers	51,500	41,700	31,500
DSL subscribers	15,600	31,200	50,000

(1) Includes lines subscribed by our incumbent local exchange carrier retail customers and lines subscribed by our "wholesale" customers who are competing local exchange carriers. Wholesale access lines include: lines subscribed by our local exchange carrier competitors pursuant to interconnection agreements on an unbundled network element basis, for which the competitive local exchange carrier pays us a monthly fee; lines that we provide to competitive local exchange carriers for resale to their subscribers, for which the competitive local exchange carrier pays us a monthly fee equal to what we would charge our customers for local service less an agreed discount; and shared lines, for which a competitive local exchange carrier pays us a monthly fee to provide DSL service to its customers. We had 3,100 wholesale lines subscribed at December 31, 2006; 3,200 at December 31, 2005; and 4,600 at December 31, 2004.

(2) Access lines subscribed by retail customers of our competitive local exchange carrier subsidiaries.

We intend to continue our strategy of increasing revenues by cross-selling services to our existing customer base, in the form of both bundled service packages and individual additional services. Between December 31, 2004 and December 31, 2006, total long distance service subscribers increased by 10,800, total DSL Internet access service subscribers increased by 34,400, and total dial-up Internet access service subscribers decreased by 20,000, with much of the decrease in total dial-up subscribers being a reflection of customer migration from dial-up to DSL service.

The following is a discussion of the major factors affecting our access line counts:

Competition. Competitive local exchange carriers are offering service in approximately 44 of the 418 incumbent local exchange communities that we serve.

In addition, we have experienced and expect to continue experiencing some line losses due to competition from wireless providers, but cannot precisely quantify the effect of this competition on us. We are responding proactively to wireless competition by offering bundled service packages that include blocks of long distance minutes. These packages are designed to meet the demand of our customers who wish to purchase both local and long distance services in a package, as is typically offered by wireless providers.

Our rates for many of our retail local exchange services have been deregulated on both an exchange-by-exchange and a service-by-service basis. The Iowa Utilities Board has determined that all of the retail local exchange services we provide in 28 exchanges are subject to effective competition and has deregulated our rates in those exchanges.

Table of Contents

Retail local exchange service deregulation became effective on July 1, 2005, pursuant to our election to deregulate our rates for all of our retail local exchange services except for single line flat-rated business and residential service and extended area service ("EAS") in accordance with legislation enacted by the Iowa General Assembly in March 2005. In addition, single line flat-rated business and residential service and EAS will also be deregulated as of July 1, 2008 unless the Iowa Utilities Board determines that the public interest requires it to extend its jurisdiction over such services to July 1, 2010. This legislation also provides us the opportunity to increase rates for services that remain price regulated, as discussed in more detail below. We believe that the gradual deregulation of our business, on an exchange-by-exchange, and a service-by-service basis, will enable us to better respond to competitive offerings by other providers.

Mediacom's telephony affiliate, MCC Telephony of Iowa, Inc. ("MCC") has stated that it intends to offer voice services in certain of the communities where we operate as the incumbent local exchange carrier through a business arrangement with Sprint Communications L. P. ("Sprint") pursuant to an interconnection agreement approved by the Iowa Utilities Board on April 24, 2006. On June 23, 2006, we filed a complaint against the Iowa Utilities Board and Sprint in the U. S. District Court for the Southern District of Iowa asking the court to rule that the Iowa Utilities Board acted unlawfully when it required us to enter into the agreement with Sprint and asking the court to invalidate the agreement. Notwithstanding the filing of our federal complaint, we have negotiated, mediated and litigated with Sprint and, at times, with MCC, to resolve issues relating to interpretation and implementation of the interconnection agreement. On January 22, 2007, we filed a second complaint against the Iowa Utilities Board and Sprint in U.S. District Court asking the court to rule that the Iowa Utilities Board acted unlawfully when it interpreted the interconnection agreement to require Iowa Telecom to provide certain services to Sprint, particularly in the manner requested by Sprint. In addition to the disputes pending in federal district court and before the Iowa Utilities Board, we are also defending a complaint filed by MCC on July 31, 2006, in the Iowa District Court for Polk County alleging that our refusal to accede to Sprint's negotiation demands improperly interfered with MCC's contracts and prospective customer relationships. The state court complaint seeks unspecified damages and costs and additional relief as warranted. This state court proceeding is currently stayed pending resolution of the federal complaints. How and when the disputes regarding interpretation and implementation of the interconnection agreement are ultimately resolved is uncertain, as is the ultimate outcome the federal and state litigation.

Exchange Sales. On July 1, 2006, we closed a transaction for the sale of four exchanges, representing approximately 2,000 access lines. On April 28, 2006 we closed a transaction for the sales of three exchanges, representing approximately 600 access lines.

Exchange Purchase. During July 2006, we completed the purchase of the Montezuma Mutual Telephone Company ("Montezuma Telephone"). Montezuma Telephone provides telecommunications services to 2,100 access lines, cable television service to approximately 1,350 subscribers and Internet access service to more than 950 subscribers, most of which are located in Montezuma, Iowa.

Ancillary Effects of our Data Businesses. Part of our decreasing line count has been an ancillary effect of our strategic focus on growing our dial-up and DSL Internet access service business. As our Internet service provider business expanded, some competitors have cancelled their connections to our network. These connections had historically been counted as access lines. Moreover, as we increase DSL Internet access service penetration, customer demand for second lines for dial-up Internet access service decreases accordingly because DSL Internet access service often replaces a second line dedicated to Internet usage. We believe that the revenue generated by our dial-up and DSL Internet access services outweighs the effect of these types of access line losses.

Our Retail Local Rate and Pricing Structure

As described under "Overview – Competition" above, effective July 1, 2005, the rates for all of our retail local exchange service except for single line flat-rated business and residential service and EAS were deregulated. Beginning July 1, 2005, monthly rates for single line services remaining under price regulation may

Table of Contents

be adjusted annually by one dollar for residential lines and two dollars for business lines, plus an inflation increment, up to a monthly rate cap of \$19.00 for residential lines and \$38.00 for business lines. Pursuant to a January 25, 2007 interpretation by the Iowa Utilities Board, the \$19.00 and \$38.00 limits are inclusive of any incremental inflationary adjustments and, therefore, once met, do not permit further inflationary adjustments. These rates do not, however, include charges or Extended Area Services, which, to the extent that it is offered in conjunction with single line flat-rate service, remains regulated by the Iowa Utilities Board. Single line flat-rated business and residential service and EAS will also be deregulated as of July 1, 2008 unless the Iowa Utilities Board determines that the public interest requires it to extend its jurisdiction over such services to July 1, 2010. If the Iowa Utilities Board decides to continue price regulation to 2010, both residential and business monthly rates may be increased up to two dollars during each twelve-month period of the extension and the overall rate caps of \$19.00 and \$38.00 will be eliminated.

Effective January 1, 2007, our regulated monthly single line flat-rated business rate became \$37.96. Effective February 1, 2007, our regulated monthly single line flat-rated residential rate became \$18.99. Both rates are exclusive of EAS, taxes, fees and regulatory surcharges.

Deregulation of Retail Local Service Rates

We offer a variety of bundled packages on a deregulated basis, particularly in our competitive markets. In addition, we have also exercised our ability to modify prices on single line flat-rated residential and business services in the exchanges in which such offerings are deregulated. The ability to offer these services on a deregulated basis provides us with the flexibility to more quickly respond to new competition and enhances our ability to regain market share in previously competitive exchanges. In addition, it allows us flexibility to create bundled packages that can more effectively compete against wireless and other competitors.

Our Ability to Control Operating Expenses

We strive to control expenses in order to maintain our operating margins. We anticipate that operating expenses generally will remain stable in line with revenue growth. Because some of our operating expenses, such as those relating to sales and marketing, are variable, we believe we can calibrate expenses to growth in the business to a significant degree.

Development of our Competitive Local Exchange Carrier Strategy

Part of our business strategy is to use our competitive local exchange carrier subsidiaries, ITC and IT Communications, to pursue customers in markets in close proximity to our rural local exchange carrier markets. We plan to continue this strategy by seeking growth opportunities on a low-cost, selective basis.

As of December 31, 2006, our CLEC Operations served 23,800 access lines. Our CLEC Operations accounted for 9.4% of Iowa Telecom's total access lines as of December 31, 2006. Throughout 2007, we plan to maintain a limited investment approach as we continue to grow our competitive local exchange carrier business.

Revenues

We derive our revenues from four sources:

Local Services. We receive revenues from providing local exchange telephone services. These revenues include monthly subscription charges for basic service, as well as charges for extended area service (mandatory expanded calling service to selected nearby communities at a flat monthly rate), local private line services and enhanced calling features, such as voice mail, caller ID and 3-way calling.

Network Access Services. We receive revenues from charges established to compensate us for the origination, transport and termination of calls generated by the customers of long distance carriers and for calls

Table of Contents

transported and terminated for the customers of wireless carriers. These include subscriber line charges imposed on end users, and switched and special access charges paid by carriers and others. We receive federally administered universal service support, representing approximately 1% of our total revenue in 2006, as a result of the interstate switched access support provisions of the FCC's CALLS Order to which the Company became subject in 2000. In addition, Montezuma Telephone received high cost loop universal service support amounting to less than 1% of our revenue. Switched access charges for services within Iowa are based on rates approved by the Iowa Utilities Board. Switched and special access charges for interstate and international services are based on rates approved by the FCC. The transport and termination charges paid by wireless carriers are specified in interconnection agreements negotiated with each individual wireless carrier.

Toll Services. We receive revenues for providing toll, or long distance, services to our customers. This revenue category also includes fees relating to our provision of directory assistance, operator assistance and long distance private lines.

Other Services and Sales. We receive revenues from monthly recurring charges for dial-up and DSL Internet access services. Other services and sales also include revenues from directory publishing, inside line care and the sale, installation and maintenance of customer premise voice and data equipment, or CPE.

The following table summarizes our revenues and sales from these sources:

	Revenue and Sales for Year Ended December 31,			% of Total Revenues and Sales for Year Ended December 31,		
	2004(1)	2005	2006	2004(1)	2005	2006
	(dollars in thousands)					
Local services	\$ 82,778	\$ 75,581	\$ 76,428	36%	33%	33%
Network access services	94,957	101,227	96,217	42%	44%	41%
Toll services	23,167	23,813	21,804	10%	10%	9%
Other services and sales	27,217	31,019	39,636	12%	13%	17%
Total	\$ 228,119	\$ 231,640	\$ 234,085	100%	100%	100%

- (1) Local services revenue for 2004 includes the recognition, as a result of our rate settlement with the Iowa Utilities Board in April 2004, of \$7.1 million of revenue collected in prior periods subject to refund. Excluding the prior period revenue, the percentages of total revenues and sales, for 2004 attributable to local services, network access services, toll services and other services and sales were 34%, 43%, 11%, and 12%, respectively.

Operating Expenses

Our operating expenses are categorized as cost of services and sales; selling, general and administrative expense; and depreciation and amortization.

Cost of services and sales. This includes expense for salaries and wages relating to plant operations and maintenance; other plant operations, maintenance and administrative costs; network access costs; bad debt expense; operating tax expense and cost of sales for our dial-up and DSL Internet access services and customer premise equipment products and services.

Selling, general and administrative expense. This includes expense for salaries, wages and benefits and contract service payments (e.g., legal fees) relating to customer and corporate operations; recruiting costs; expenses for travel, lodging and meals; internal communications costs; insurance premiums; and supplies and postage.

Depreciation and amortization. This includes depreciation of our telecommunications network and equipment, and amortization of intangible assets.

Table of Contents**Results of Operations**

The following table sets forth certain items reflected in our consolidated statements of income for the periods indicated, expressed as a percentage of total revenues and sales:

	Year Ended December 31,		
	2004(1)	2005	2006
Total revenue and sales	100%	100%	100%
Cost of services and sales (excluding expenses listed separately below)	24	28	29
Selling, general and administrative	17	18	20
Gain on sale of exchanges	—	—	(2)
Depreciation and amortization	21	21	20
Operating income	38	33	33
Total other expenses, net	32	13	13
Income tax expense	—	—	5
Net income	6%	20%	15%

- (1) As a result of our initial public offering in November 2004 and the concurrent refinancing of our debt, we paid, in the fourth quarter of 2004, \$18.6 million for prepayment fees on the retired debt and \$3.8 million of selling shareholder equity issuance costs. Therefore, other expense, net, which includes these additional transactions costs, increased to 32% in 2004. If we had excluded the one-time costs due to our initial public offering, other expense, net would have been 23% of total revenues.

Year ended December 31, 2006 compared to year ended December 31, 2005**Revenues and Sales**

The table below sets forth the components of our revenues and sales for 2006 as compared to 2005:

	For the year ended December 31,		Change	
	2005	2006	Amount	Percent
(dollars in thousands)				
Revenue and Sales				
Local services	\$ 75,581	\$ 76,428	\$ 847	1.1%
Network access services	101,227	96,217	(5,010)	-4.9%
Toll services	23,813	21,804	(2,009)	-8.4%
Other services and sales	31,019	39,636	8,617	27.8%
Total revenues and sales	\$ 231,640	\$ 234,085	\$ 2,445	1.1%

Local Services. Local services revenues increased \$847,000, or 1.1%, for 2006 as compared to 2005. The increase is primarily attributable to higher revenue from enhanced local services, which increased by \$900,000 due to growth of our bundled product offerings. Local rate increases also helped to offset the impact of access line erosion. From December 31, 2005 to December 31, 2006, total access lines decreased by 6,700, including the loss of 9,700 incumbent local exchange carrier lines offset by an increase in lines served by our competitive local exchange carriers of 3,000.

Network Access Services. Our network access services revenues decreased \$5.0 million, or 4.9%, for 2006 as compared to 2005. Revenues from switched access services decreased approximately \$6.6 million due to decreases in access lines, access minutes per line and in the average revenue per minute of use due to a larger

Table of Contents

shift to cellular usage. We are compensated at a slightly lower rate per minute for terminating cellular traffic. These reductions were partially offset by a \$2.3 million increase in revenue from special access services.

Toll Services. Our toll services revenues decreased by \$2.0 million, or 8.4%, for 2006 as compared to 2005. The number of long distance customers increased by approximately 3,800, or 2.7%. However, this increase was offset by a decrease in average minutes of use per customer and average revenue per minute.

Other Services and Sales. Other services and sales revenues increased by \$8.6 million, or 27.8%, for 2006 as compared to 2005. The revenue increase was in part due to growth of our CPE and data business, primarily as a result of our acquisition of Baker Communications in August 2006. Additionally, DSL Internet access service revenues increased \$5.8 million, or 51.6%, due primarily to customer growth. This increase was partially offset by decreases in dial-up Internet revenue of \$2.0 million. We believe the decline in dial-up Internet access service customers is generally the result of customer migration to broadband products such as our DSL service.

Operating Costs and Expenses

The table below sets forth the components of our operating costs and expenses for 2006 as compared to 2005.

	For the year ended December 31,		Change	
	2005	2006	Amount	Percent
	(dollars in thousands)			
Operating Costs and Expenses:				
Cost of services and sales (exclusive of items shown separately below)	\$ 64,118	\$ 66,528	\$ 2,410	3.8%
Selling, general and administrative	41,708	46,336	4,628	11.1%
Gain on sale of properties	—	(4,194)	(4,194)	NA
Depreciation and amortization	48,600	47,736	(864)	-1.8%
Total operating costs and expenses	<u>\$ 154,426</u>	<u>\$ 156,406</u>	<u>\$ 1,980</u>	<u>1.3%</u>

Cost of Services and Sales. Cost of services and sales increased \$2.4 million, or 3.8%, for 2006 as compared to 2005. The increase was principally due to growth of our CPE and data business, primarily as a result of our acquisition of Baker Communications in August 2006.

Selling, General and Administrative Costs. Selling, general and administrative costs increased \$4.6 million, or 11.1%, for 2006 as compared to 2005. The 2006 period included a pension settlement charge of approximately \$3.0 million as compared to pension settlement charges of \$1.5 million during 2005. During the second quarter of 2005, we amended our defined benefit pension plan. As a result of the amendment, the benefits to be paid to salaried participants at their normal retirement age of 65 are fixed. The accrued benefits for certain hourly employees subject to a mandatory benefit freeze and for those who elected to discontinue further benefit accruals were transferred to a separate plan (the "Spin-Off Plan"), which was terminated during the fourth quarter of 2006. Non-cash equity-based compensation expense for 2006 was \$526,000 higher than the prior year. The 2005 period included a \$2.0 million benefit resulting from past access disputes with other carriers.

Gain on sale of Properties. The 2006 period included a \$4.2 million gain on the sale of exchanges.

Depreciation and Amortization. Depreciation and amortization decreased \$864,000, or 1.8%, for 2006 as compared to 2005. The decrease was due to the elimination of depreciation expense on certain five-year assets in the latter part of 2005 and a reduction in our composite average depreciation rate as a result of a depreciation study that was completed during the first quarter of 2006. The lower composite average depreciation rate reduced expense during 2006 by approximately \$500,000.

Table of Contents*Other Income (Expense)*

The table below sets forth other income (expense) for the year ended December 31, 2006 as compared to the same period for 2005.

	For the year ended December 31,		Change	
	2005	2006	Amount	Percent
	(dollars in thousands)			
Other Income (Expense)				
Interest and dividend income	\$ 1,078	\$ 953	\$ (125)	-11.6%
Interest expense	(31,089)	(31,708)	(619)	2.0%
Other, net	(813)	(572)	241	-29.6%
Total other expense	\$ (30,824)	\$ (31,327)	\$ (503)	1.6%

Interest and Dividend Income. Interest and dividend income decreased \$125,000, or 11.6%, primarily due to higher dividend income from the RTFC during 2005.

Interest Expense. Interest expense increased \$619,000, or 2.0%, for 2006 as compared to 2005 principally as a result of higher interest rates on our variable rate debt and the increase in the rate on our interest rate swap agreement, resulting from the extension of the term in August 2005.

Other, Net. Other, net was a net expense of \$572,000 for 2006, compared to \$813,000 in 2005. The expense for 2005 included \$579,000 of costs related to an amendment to our credit agreement.

Income Tax Expense

A valuation allowance had been recorded at December 31, 2005 for our deferred tax assets that expire over time to the extent that they exceeded the net deferred tax assets and liabilities resulting from reversing temporary differences. We determined that, based upon the evidence available as of December 31, 2006, that the combination of the continued generation of taxable income and the taxable income generated from reversing temporary differences will be, more likely than not, sufficient to utilize the entire deferred tax asset. As such, we have determined that no valuation allowance was required for our deferred tax assets, and we reversed the remaining valuation allowance during the period.

Income tax expense for 2006, before adjustments to the deferred tax valuation allowance, was \$19.5 million. As a result of reversing the remaining valuation allowance during 2006, income tax expense was reduced by \$7.2 million, resulting in net expense for the period of \$12.3 million.

Our initial public offering resulted in an ownership change for purposes of Section 382 of the Internal Revenue Code, and consequently our ability to utilize our net operating losses will be subject to limitation each year. We currently anticipate that, as a result of such ownership change, we will generally be limited by Section 382 to utilizing approximately \$19 million of our pre-transaction net operating losses annually. However, Internal Revenue Code Section 338 allows for an increase in this allowance by an additional \$762,000, \$37.4 million, \$26.3 million, \$18.7 million and \$17.2 million, for tax periods ending in 2005 through 2009, respectively. After 2009, the IRC Section 382 limitation will apply. At December 31, 2006, the company had unused tax net operating loss carryforwards of approximately \$185 million which expire in 2020 to 2024. Furthermore, we expect that we will continue to be able to take deductions related to the amortization of intangibles in excess of the amount recorded for book purposes in the amount of approximately \$40 million annually through 2014.

Table of Contents**Year ended December 31, 2005 compared to year ended December 31, 2004***Revenues and Sales*

The table below sets forth the components of our revenues and sales for 2005 as compared to 2004:

	For the year ended December 31,		Change	
	2004	2005	Amount	Percent
(dollars in thousands)				
Revenue and Sales				
Local services	\$ 82,778	\$ 75,581	\$ (7,197)	-8.7%
Network access services	94,957	101,227	6,270	6.6%
Toll services	23,167	23,813	646	2.8%
Other services and sales	27,217	31,019	3,802	14.0%
Total revenues and sales	<u>\$ 228,119</u>	<u>\$ 231,640</u>	<u>\$ 3,521</u>	<u>1.5%</u>

Local Services. Local services revenues decreased \$7.2 million, or 8.7%, for 2005, as compared to 2004, primarily due to \$7.1 million of revenue collected subject to refund in prior periods and recognized during 2004. Our new rates established under the settlement agreement with the Iowa Utilities Board became effective on April 23, 2004. Also contributing to the decrease was the loss of \$3.6 million in revenues resulting from the discontinuance of the expanded local area calling plans during the third quarter of 2004, as more fully described below, and the decrease in total access lines. These reductions were partially offset by the benefit of the April 23, 2004 rate increase for the entire period of 2005, which resulted in additional revenue of \$2.3 million. In addition, we experienced an increase in revenue from enhanced local services of \$1.1 million for 2005 as compared to 2004, due to the growth of bundled product offerings. From December 31, 2004 to December 31, 2005, total access lines decreased by 8,300 including the loss of 13,900 incumbent local exchange carrier lines and an increase in lines served by our competitive local exchange carriers of 5,600.

Our historical ability to provide expanded local calling plans at favorable margins depended on the existence of an agreement for mutual exchange of traffic with another telecommunications provider. That agreement terminated on July 31, 2004. As a result, we discontinued the expanded local calling plans and encouraged customers who subscribed to our expanded local calling plans to replace those plans with substitute services. The termination of the agreement for mutual exchange of traffic and discontinuance of our expanded local calling plans have affected several of our revenue streams and our costs of services and sales. Local services revenue for 2004 included \$3.6 million from the expanded local calling plans that have been discontinued. While that revenue stream has ended, we have increased our long distance and access revenues as subscribers migrate from our expanded local calling plans to toll plans.

Network Access Services. Our network access services revenues increased \$6.3 million, or 6.6%, for 2005 as compared to 2004. Revenues from switched access services increased approximately \$6.2 million, due primarily to an increase in access minutes per line which is due in part to the elimination of the expanded local calling plans.

Toll Services. Our toll services revenues increased by \$646,000, or 2.8%, for 2005 as compared to 2004. This revenue growth was attributable to an increase in the number of long distance customers of approximately 7,000, or 5.2%, partially offset by a decrease in average minutes of use per customer and average revenue per minute.

Other Services and Sales. Other services and sales revenues increased by \$3.8 million, or 14.0%, for 2005 as compared to 2004. The revenue increase was primarily due to growth in the number of DSL Internet customers. DSL Internet access service revenues increased \$5.5 million, or 97.5%, due primarily to customer growth. This increase was partially offset by a decrease in dial-up Internet-revenues of \$1.1 million and a decline

Table of Contents

in revenue from customer premise equipment sales of \$483,000. We believe the decline in dial-up Internet access service customers is generally the result of customer migration to broadband products such as our DSL service.

Operating Costs and Expenses

The table below sets forth the components of our operating costs and expenses for 2005 as compared to 2004.

	For the year ended December 31,		Change	
	2004	2005	Amount	Percent
	(dollars in thousands)			
Operating Costs and Expenses:				
Cost of services and sales (exclusive of items shown separately below)	\$ 55,766	\$ 64,118	\$ 8,352	15.0%
Selling, general and administrative	37,418	41,708	4,290	11.5%
Depreciation and amortization	47,941	48,600	659	1.4%
Total operating costs and expenses	\$ 141,125	\$ 154,426	\$ 13,301	9.4%

Cost of Services and Sales. Cost of services and sales increased \$8.4 million, or 15.0%, for 2005 as compared to 2004. The increase in long distance customers, coupled with the termination of the historical agreement for the exchange of traffic related to our discontinued local calling plans, resulted in approximately \$4.4 million of additional cost to deliver long distance traffic. As a result of customer growth, we experienced an increase in competitive local exchange carrier access lines which, in turn, raised costs for providing this service by \$3.3 million for 2005 as compared to 2004.

Selling, General and Administrative Costs. Selling, general and administrative costs increased \$4.3 million, or 11.5%, for 2005 as compared to 2004. The 2005 period includes a \$2 million favorable impact resulting from past access disputes with other carriers. Offsetting this favorable impact was a \$4.8 million increase in salary, wages and benefits, \$1.4 million of external costs related to Sarbanes Oxley compliance and other costs related to being a publicly traded company. Salary, wages and benefits for 2005 includes a pension settlement charge of approximately \$1.5 million for distributions related to amendments to the pension plan during the second quarter of 2005. The amendments to the plan will reduce our future pension obligations. Also contributing to the increase in salaries, wages and benefits was additional non-cash equity-based compensation expense of \$1.7 million related to exercise price reductions on vested outstanding stock options under the 2002 Stock Incentive Plan to reflect the dividends on our common stock and expense for the unvested shares issued under the 2005 Stock Incentive Plan.

Depreciation and Amortization. Depreciation and amortization increased \$659,000, or 1.4%, for 2005 as compared to 2004. This was primarily due to higher average property, plant and equipment balances relating mainly to additions to our network facilities.

Other Income (Expense)

The table below sets forth other income (expense) for the year ended December 31, 2005 as compared to the same period for 2004.

	For the year ended December 31,		Change	
	2004	2005	Amount	Percent
	(dollars in thousands)			
Other Income (Expense)				
Interest and dividend income	\$ 4,057	\$ 1,078	\$ (2,979)	-73.4%
Interest expense	(55,654)	(31,089)	24,565	-44.1%
Other, net	(21,193)	(813)	20,380	-96.2%
Total other expense	\$ (72,790)	\$ (30,824)	\$ 41,966	-57.7%

Table of Contents

Interest and Dividend Income. Interest and dividend income decreased \$3.0 million, or 73.4%, primarily due to the reduction in patronage dividend income from the Rural Telephone Finance Cooperative Subordinated Capital Certificates, which were partially redeemed in connection with the initial public offering and debt refinancing in November 2004.

Interest Expense. Interest expense decreased \$24.6 million, or 44.1%, for 2005 as compared to 2004, principally as a result of the reductions in the amount of debt outstanding, and in the average interest rate on our new debt issued in connection with our debt refinancing in November 2004.

Other, Net. Other, net was a net expense of \$813,000 for 2005 compared to \$21.2 million in 2004. The expense for 2005 includes \$579,000 of costs related to an amendment to our credit agreement, which resulted in a reduction in the interest rate on the Term B loans, and our interest rate swap agreement as described in "Long-Term Debt and Credit Facilities." The costs in 2004 relate primarily to our initial public offering, which resulted in one-time expenses of \$22.4 million in the fourth quarter of 2004. The transaction-related expenses included prepayment fees on the retired debt of \$18.6 million and \$3.8 million of selling shareholder equity issuance costs.

Income Tax Expense: A valuation allowance had been provided at December 31, 2005 for our deferred tax assets that expire over time to the extent that they exceed the net deferred tax assets and liabilities resulting from reversing temporary differences. Prior to fiscal 2005, we had not paid income taxes. During fiscal 2005, we paid \$140,000 of alternative minimum tax.

As of December 31, 2005, the balance of the valuation allowance was approximately \$6 million. Our unused tax net operating loss carryforward was approximately \$211 million, and will expire between 2020 and 2024. As of December 31, 2005 we have a \$140,000 Alternative Minimum Tax ("AMT") credit carryforward. No valuation allowance has been provided for the AMT credit carryforward due to its indefinite life.

Redemption of Preferred Stock: On March 26, 2004, we repurchased our Series A mandatorily redeemable convertible preferred stock and related accrued dividends for an aggregate purchase price of \$100 million. The recorded amounts of the preferred stock and the related accrued preferred stock dividend were \$125 million and \$32.7 million, respectively, as of the redemption date of March 26, 2004.

Liquidity and Capital Resources

Our short-term and long-term liquidity requirements arise primarily from: (i) interest payments related to our credit facilities; (ii) capital expenditures; (iii) working capital requirements; (iv) dividend payments on our common stock; (v) potential acquisitions and (vi) our pension obligation as described below.

The table below reflects the dividends declared or paid by the Company during 2006:

<u>Date Declared</u>	<u>Dividend Per Share</u>	<u>Record Date</u>	<u>Payment Date</u>
December 16, 2005	\$0.405	December 30, 2005	January 17, 2006
March 17, 2006	\$0.405	March 31, 2006	April 17, 2006
June 15, 2006	\$0.405	June 30, 2006	July 17, 2006
September 15, 2006	\$0.405	September 29, 2006	October 16, 2006
December 15, 2006	\$0.405	December 29, 2006	January 16, 2007

Our intention is to distribute a substantial portion of the cash generated by our business to our shareholders in regular quarterly dividends to the extent we generate cash in excess of operating needs, interest and principal payments on our indebtedness, and capital expenditures.

We intend to fund our operations, interest expense, capital expenditures, working capital requirements and dividend payments on our common stock with cash from operations. For 2006 and 2005, cash provided by operating activities was \$89.5 million and \$97.3 million, respectively.

Table of Contents

IOWA TELECOMMUNICATIONS SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
AS OF DECEMBER 31, 2005 AND 2006
(Dollars in Thousands Except Per Share Amounts)

	<u>2005</u>	<u>2006</u>
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 26,782	\$ 13,613
Accounts receivable, net	18,121	20,828
Inventories	2,722	3,124
Prepayments and other current assets	2,402	2,550
Total Current Assets	<u>50,027</u>	<u>40,115</u>
PROPERTY, PLANT AND EQUIPMENT:		
Property, plant and equipment	504,662	521,556
Accumulated depreciation	(189,163)	(222,581)
Net Property, Plant and Equipment	<u>315,499</u>	<u>298,975</u>
GOODWILL	460,113	466,554
INTANGIBLE ASSETS AND OTHER, net	23,993	39,982
INVESTMENT IN AND RECEIVABLE FROM THE RURAL TELEPHONE FINANCE COOPERATIVE	14,890	13,903
Total Assets	<u>\$ 864,522</u>	<u>\$ 859,529</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Revolving credit facility	\$ 40,000	\$ 31,000
Accounts payable	10,416	9,565
Advanced billings and customer deposits	6,042	8,460
Accrued and other current liabilities	29,842	32,035
Total Current Liabilities	<u>86,300</u>	<u>81,060</u>
LONG-TERM DEBT	477,778	477,778
DEFERRED TAX LIABILITIES	—	18,716
OTHER LONG-TERM LIABILITIES	19,913	14,276
Total Liabilities	<u>583,991</u>	<u>591,830</u>
COMMITMENTS AND CONTINGENCIES (Notes 7, 12 and 16)		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$0.01 par value, 50,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock, \$0.01 par value, 100,000,000 shares authorized, 31,065,963 and 31,379,670 issued and outstanding, respectively	311	314
Additional paid-in capital	317,877	322,016
Retained deficit	(42,874)	(59,976)
Accumulated other comprehensive income	5,217	5,345
Total Stockholders' Equity	<u>280,531</u>	<u>267,699</u>
Total Liabilities and Stockholders' Equity	<u>\$ 864,522</u>	<u>\$ 859,529</u>

See notes to consolidated financial statements.

Table of Contents

IOWA TELECOMMUNICATIONS SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
FOR THE YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006
(Dollars in Thousands, Except Per Share Amounts)

	2004	2005	2006
REVENUE AND SALES:			
Local services	\$ 82,778	\$ 75,581	\$ 76,428
Network access services	94,957	101,227	96,217
Toll services	23,167	23,813	21,804
Other services and sales	27,217	31,019	39,636
Total Revenues and Sales	<u>228,119</u>	<u>231,640</u>	<u>234,085</u>
OPERATING COSTS AND EXPENSES:			
Cost of services and sales (exclusive of items shown separately below)	55,766	64,118	66,528
Selling, general and administrative	37,418	41,708	46,336
Gain on sale of properties	—	—	(4,194)
Depreciation and amortization	47,941	48,600	47,736
Total Operating Costs and Expenses	<u>141,125</u>	<u>154,426</u>	<u>156,406</u>
OPERATING INCOME	<u>86,994</u>	<u>77,214</u>	<u>77,679</u>
OTHER INCOME (EXPENSE):			
Interest and dividend income	4,057	1,078	953
Interest expense	(55,654)	(31,089)	(31,708)
Other, net	(21,193)	(813)	(572)
Total Other Expense, net	<u>(72,790)</u>	<u>(30,824)</u>	<u>(31,327)</u>
EARNINGS BEFORE INCOME TAXES	<u>14,204</u>	<u>46,390</u>	<u>46,352</u>
INCOME TAX EXPENSE	—	—	12,309
NET INCOME	<u>14,204</u>	<u>46,390</u>	<u>34,043</u>
GAIN ON REDEMPTION OF REDEEMABLE CONVERTIBLE PREFERRED STOCK	57,681	—	—
PREFERRED DIVIDEND	<u>(2,056)</u>	<u>—</u>	<u>—</u>
INCOME AVAILABLE FOR COMMON STOCKHOLDERS	<u>\$ 69,829</u>	<u>\$ 46,390</u>	<u>\$ 34,043</u>
EARNINGS PER SHARE:			
Basic	<u>\$ 2.97</u>	<u>\$ 1.50</u>	<u>\$ 1.09</u>
Diluted	<u>\$ 2.64</u>	<u>\$ 1.46</u>	<u>\$ 1.06</u>

See notes to consolidated financial statements.

Table of Contents

IOWA TELECOMMUNICATIONS SERVICES, INC. AND SUBSIDIARIES

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND
COMPREHENSIVE INCOME
FOR THE YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006**
(Dollars in Thousands Except Per Share Amounts)

	Common Shares	Common Stock	Additional Paid-In Capital	Retained Deficit	Accumulated Other Comprehensive Income (Loss)	Total
BALANCE, December 31, 2003	22,601,037	\$ 226	\$ 179,774	\$ (103,325)	\$ —	\$ 76,675
Income available for common stockholders	—	—	—	69,829	—	69,829
Unrealized gains (losses) on derivatives	—	—	—	—	(84)	(84)
Total comprehensive income (loss)	—	—	—	69,829	(84)	69,745
Issuance of common stock, net of issuance costs	8,263,158	83	144,765	—	—	144,848
Dividends declared (\$0.175 per share)	—	—	—	(5,401)	—	(5,401)
Redemption of stock options	—	—	(10,046)	—	—	(10,046)
Compensation from compensatory stock options	—	—	141	—	—	141
BALANCE, December 31, 2004	30,864,195	309	314,634	(38,897)	(84)	275,962
Income available for common stockholders	—	—	—	46,390	—	46,390
Unrealized gains on derivatives	—	—	—	—	11,119	11,119
Minimum pension liability adjustment	—	—	—	—	(5,818)	(5,818)
Total comprehensive income	—	—	—	46,390	5,301	51,691
Compensation from compensatory stock options	1,356	—	1,828	—	—	1,828
Exercise of employee stock options	200,412	2	1,415	—	—	1,417
Dividends declared (\$1.62 per share)	—	—	—	(50,367)	—	(50,367)
BALANCE, December 31, 2005	31,065,963	311	317,877	(42,874)	5,217	280,531
Income available for common stockholders	—	—	—	34,043	—	34,043
Unrealized earnings on derivatives, net of tax	—	—	—	—	(3,388)	(3,388)
Minimum pension liability adjustment, net of tax	—	—	—	—	5,192	5,192
Total comprehensive income	—	—	—	34,043	1,804	35,847
Compensation from compensatory stock options	779	—	2,354	—	—	2,354
Exercise of employee stock options	312,928	3	1,737	—	—	1,740
Income tax benefit related to stock options	—	—	48	—	—	48
Dividends declared (\$1.62 per share)	—	—	—	(51,145)	—	(51,145)
Initial impact upon adoption of SFAS No. 158	—	—	—	—	—	—
Pension, net of taxes	—	—	—	—	(1,071)	(1,071)
Other postretirement obligations, net of taxes	—	—	—	—	(605)	(605)
BALANCE, December 31, 2006	31,379,670	\$ 314	\$ 322,016	\$ (59,976)	\$ 5,345	\$ 267,699

See notes to consolidated financial statements

Table of Contents

IOWA TELECOMMUNICATIONS SERVICES, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006
(Dollars in Thousands)

	2004	2005	2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	\$ 14,204	\$ 46,390	\$ 34,043
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation	45,576	46,213	45,627
Amortization of intangible assets	2,365	2,387	2,109
Amortization of debt issuance costs	784	591	591
Gain on sale of properties	—	—	(4,194)
Deferred income taxes	—	—	11,680
Non-cash stock based compensation expense	141	1,828	2,354
Loss from fees to retire existing debt	18,557	—	—
Write-off of deferred financing costs	3,568	—	—
Changes in operating assets and liabilities, net of effects of business acquisitions:			
Receivables	(2,600)	1,295	(199)
Inventories	(51)	257	(214)
Accounts payable	3,044	(5,473)	(1,742)
Other assets and liabilities	(8,953)	3,833	(562)
Net Cash Provided by Operating Activities	<u>76,635</u>	<u>97,321</u>	<u>89,493</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Capital expenditures	(34,803)	(30,141)	(28,122)
Business acquisitions (net of cash acquired)	(1,697)	(94)	(18,115)
Purchase of wireless licenses	—	—	(11,473)
Proceeds from sale of properties	—	—	13,287
Redemption of RTFC capital certificates	50,000	—	—
Purchase of RTFC capital certificates	(7,778)	—	—
Net Cash Provided by (used in) Investing Activities	<u>5,722</u>	<u>(30,235)</u>	<u>(44,423)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net change in revolving credit facility	41,507	(1,507)	(9,000)
Redemption of redeemable preferred stock	(100,000)	—	—
Issuance of senior subordinated notes	66,000	—	—
Payment of issuance costs for senior subordinated notes	(1,974)	—	—
Early retirement of long-term debt	(681,500)	—	—
Payment of fees to retire debt	(18,557)	—	—
Issuance of long-term debt	477,778	—	—
Payment of issuance costs for long term debt	(4,138)	—	—
Issuance of common stock, net of issuance costs	144,848	—	—
Redemption of stock options	(10,046)	—	—
Payment on long-term debt	(30,250)	—	—
Proceeds from exercise of stock options	—	1,417	1,740
Dividends paid	—	(43,088)	(50,979)
Net Cash Used in Financing Activities	<u>(116,332)</u>	<u>(43,178)</u>	<u>(58,239)</u>
NET CHANGE IN CASH AND CASH EQUIVALENTS	<u>(33,975)</u>	<u>23,908</u>	<u>(13,169)</u>
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	<u>36,849</u>	<u>2,874</u>	<u>26,782</u>
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 2,874</u>	<u>\$ 26,782</u>	<u>\$ 13,613</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid for interest	\$ 50,823	\$ 31,930	\$ 31,024
Cash paid for income taxes	\$ —	\$ 140	\$ 964

SUPPLEMENTAL NONCASH INVESTING AND FINANCING ACTIVITIES:

During the years ended December 31, 2004, 2005 and 2006, the Company recorded undeclared and unpaid preferred stock dividends of \$2,056, \$0 and \$0, respectively.

Dividends on common stock of \$5,401 were declared on December 17, 2004 and paid on January 17, 2005. Dividends on common stock of \$12,680 were declared on December 16, 2005 for shareholders of record as of December 30, 2005 and paid on January 17, 2006. Dividends on common stock of \$12,846 were declared on December 15, 2006 for shareholders of record as of December 29, 2006 and paid on January 16, 2007.

See notes to consolidated financial statements.

Table of Contents

IOWA TELECOMMUNICATIONS SERVICES, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2004, 2005 AND 2006

1. ORGANIZATION

Business Description—Iowa Telecommunications Services, Inc. and subsidiaries (“Iowa Telecom” or the “Company”) is the second largest incumbent local exchange carrier (ILEC) in the State of Iowa and is estimated to be one of the top 20 largest ILECs in the United States, with an integrated telecommunications network serving approximately 288 local exchanges with approximately 252,000 total access lines. Iowa Telecom provides local, long distance and Internet access and communications equipment primarily to rural residential and business customers, and provides access services to interexchange carriers (IXCs) and other communications companies. The Company primarily operates on a regulatory basis under intrastate price cap regulation in the State of Iowa and under various FCC regulations for its interstate services. The Company manages its business as one operating segment.

Basis of Consolidation—The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Iowa Telecommunications Services, Inc., the parent company, is an operating company. For 2006, the parent company represents approximately 93% of total revenues, approximately 96% of net income and over 97% of total assets of the consolidated company. The subsidiaries, individually and in the aggregate, are not material as they represent less than 10 % of consolidated revenue, earnings and total assets.

Revenue Recognition—Revenue is recognized when evidence of an arrangement exists, the earning process is complete and collectibility is reasonably assured. The prices for regulated services are filed in tariffs with the appropriate regulatory bodies that exercise jurisdiction over the various services.

Local Services—Monthly recurring local line charges are billed to end users in advance. Revenue is recognized during the period these services are rendered. Billed but unearned revenue is deferred and recorded as a current liability included in advance billings and customer deposits.

Network Access Services—Network access revenue primarily consists of switched access revenue billed to other carriers. Switched access revenue is billed in arrears based on originating and terminating minutes of use. Earned but unbilled switched access revenue is included in receivables. Network access revenue also contains special access revenue. Special access revenue is billed in advance based on recurring fees and recognized in revenue during the period services are provided. Network access revenue and special access revenue is recognized in the month services are provided.

Toll Services—Toll services are typically billed to end users in arrears based on actual usage. Earned but unbilled toll services are included in receivables. Toll service revenue is recognized in the month services are provided.

Other Services and Sales—Other services and sales consist primarily of dial-up and DSL Internet access services. Other services and sales also include revenues from directory publishing, inside line care and the sale, installation and maintenance of customer premise voice and data equipment, or CPE. The monthly recurring charges for dial-up and DSL Internet access services and inside line care are billed to end users in advance. Revenue is recognized during the period these services are provided. Billed but unearned revenue is included in advance billings and customer deposits. The Company recognizes directory services revenue on a straight-line basis over the twelve month period in which the corresponding directory is distributed. The Company recognizes the revenue from the sale and maintenance of CPE in the period the sale or service is rendered.



Form 10-K

WINDSTREAM CORP - WIN

Filed: March 01, 2007 (period: December 31, 2006)

Annual report which provides a comprehensive overview of the company for the past year

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONSBasis of Presentation

On July 17, 2006, Windstream Corporation ("Windstream or the "Company") completed the spin-off from Alltel Corporation ("Alltel") and the subsequent merger with Valor Communications Group Inc. ("Valor"), as further discussed below under "Acquisition." For periods prior to the spin-off from Alltel, the Company's consolidated financial statements were derived from the accounting records of Alltel, principally representing Alltel's historical wireline and communications support segments. The Company has used the historical results of operations, and historical basis of assets and liabilities of the subsidiaries it owns and the wireline business it operates after completion of the spin-off, to prepare the consolidated financial statements for periods prior to the spin-off. For the periods through July 17, 2006, certain services such as information technology, accounting, legal, tax, marketing, engineering, and risk and treasury management were provided to the Company by Alltel. These expenses have been allocated based on actual direct costs incurred. Where specific identification of expenses was not practicable, the cost of such services was allocated based on the most relevant allocation method to the service provided: either net sales of the Company as a percentage of net sales of Alltel, total assets of the Company as a percentage of total assets of Alltel, or headcount of the Company as a percentage of headcount of Alltel.

Management of both the Company and Alltel considered these allocations to be a reasonable reflection of the utilization of services provided.

The Company is organized based on the products and services that it offers. Under this organizational structure, its operations consist of its wireline and product distribution segments and other operations. The Company's wireline segment consists of its retail and wholesale telecommunications services, including local, long distance, network access, video services, broadband and data services. The product distribution segment consists of warehouse and logistics operations, and it procures and sells telecommunications infrastructure and equipment to both affiliated and non-affiliated businesses. The Company's other operations include the Company's directory publishing and telecommunications information services operations. After the merger with Valor, telecommunications information services are no longer offered as Valor was the sole remaining external customer. As discussed in detail below, the Company has announced that it will split off the directory publishing business in 2007.

The management of the Company believes that the assumptions underlying its consolidated financial statements are reasonable. However, the Company's consolidated financial statements included herein may not necessarily reflect its results of operations, financial position and cash flows in the future, or what its results of operations, financial position and cash flows would have been had it been a separate, stand-alone company during the periods prior to the spin-off from Alltel. The following discussion should be read in conjunction with the consolidated financial statements and the related notes as of December 31, 2006.

Executive Summary of 2006 Results

Windstream is a customer-focused telecommunications company that provides local telephone, long distance, network access, video services, broadband and high-speed data services to over 3.2 million residential and business customers primarily located in rural areas in 16 states. Among the highlights in 2006:

- On July 17, 2006, the Company completed the spin-off from Alltel and the subsequent merger with Valor. This acquisition is significant to the Company because it expanded its retail presence into new markets by adding approximately 500,000 access lines in four states. The resulting company represents the largest telecommunications carrier in the United States focusing primarily on rural markets, and should have greater financial flexibility to develop and deploy products, expand the capacity of its network, respond to competitive pressures and improve the cost structure of its operations due to the resulting increased size and economies of scale.
- In the twelve month period ended December 31, 2006, the Company added approximately 258,000 broadband customers, including 67,000 acquired with Valor. This increased our broadband customer base to over 656,000, or 20 percent of total access lines. The growth in broadband customers continues to more than offset the loss of local access lines.
- Revenues and sales increased \$109.8 million as compared with 2005, due primarily to the acquisition of Valor. Excluding the acquisition, revenues and sales decreased \$112.5 million, primarily due to the increase in

intercompany eliminations due to the discontinuance of the application of Statement of Financial Accounting Standard ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation," as further discussed below, and the loss of access lines discussed below. Average revenue per wireline customer, however, increased four percent from a year ago to \$75.29 due primarily to growth in broadband revenues.

- Operating income increased 42 percent from a year ago, primarily reflecting the acquisition of Valor, the termination of a licensing agreement with Alltel as of June 30, 2006, and a decline in depreciation and amortization resulting from reductions in depreciable lives for certain assets associated with studies performed during 2005 and 2006.

During 2007, the Company will continue to face significant challenges resulting from competition in the telecommunications industry and changes in the regulatory environment, including the effects of potential changes to the rules governing universal service funding and inter-carrier compensation. In addressing competition, the Company will continue to focus its efforts on improving customer service and expanding its service offerings.

Acquisition

On July 17, 2006, Alltel completed the spin-off of its wireline telecommunications business to its stockholders (the "Distribution") and the merger of that wireline business with Valor (the "Merger"). For all periods prior to the effective time of the Merger, references to the Company include Alltel Holding Corp. or the wireline telecommunications division and related businesses of Alltel. Pursuant to the plan of Distribution and immediately prior to the effective time of the Merger with Valor described below, Alltel contributed all of its wireline assets in exchange for: (i) newly issued Company common stock, (ii) the payment of a special dividend to Alltel in the amount of \$2.3 billion and (iii) the distribution by the Company to Alltel of certain debt securities (the "Contribution").

In connection with the Contribution, the Company assumed approximately \$261.0 million of long-term debt that had been issued by the Company's wireline subsidiaries. Also in connection with the Contribution the Company borrowed approximately \$2.4 billion through a new senior secured credit agreement that was used to fund the special dividend and pay down a portion of the \$261.0 million in long-term debt assumed by the Company in the Contribution. The debt securities issued by the Company to Alltel as part of the Contribution consisted of 8.625 percent senior notes due 2016 with an aggregate principal amount of \$1,746.0 million (the "Company Securities"). These securities were issued at a discount, and accordingly, at the date of their distribution to Alltel, the Company Securities had a carrying value of \$1,703.2 million (par value of \$1,746.0 million less discount of \$42.8 million). Following the Contribution, Alltel distributed 100 percent of the common shares of the Company to its shareholders as a tax-free dividend. Alltel also exchanged the Company Securities for certain Alltel debt held by certain investment banking firms. The investment banking firms subsequently sold the Company Securities in the private placement market. On November 28, 2006, the Company replaced the Company Securities with registered senior notes in the same amount with the same maturity.

Immediately after the consummation of the spin-off, the Company merged with and into Valor, with Valor continuing as the surviving corporation. The resulting company was renamed Windstream Corporation. As a result of the merger, all of the issued and outstanding shares of the Company's common stock were converted into the right to receive an aggregate number of shares of common stock of Valor. Valor issued in the aggregate approximately 403 million shares of its common stock to Alltel shareholders pursuant to the Merger, or 1.0339267 shares of Valor common stock for each share of the Company's common stock outstanding as of the effective date of the Merger. Upon completion of the Merger, Alltel's stockholders owned approximately 85 percent of the outstanding equity interests of the surviving corporation, Windstream, and the stockholders of Valor owned the remaining approximately 15 percent of such equity interests. In addition, Windstream assumed Valor debt valued at \$1,195.6 million.

Immediately following the Merger, the Company issued 8.125 percent senior notes due 2013 in the aggregate principal amount of \$800.0 million, which was used in part to pay down the Valor credit facility in the amount of \$780.6 million. As a result of the aforementioned financing transactions, Windstream assumed or incurred approximately \$5.5 billion of long-term debt in connection with the Contribution and the Merger.

Pending Transaction

On December 12, 2006, Windstream announced that it would split off its directory publishing business (the "Publishing Business") in what Windstream expects to be a tax-free transaction with entities affiliated with Welsh,

Carson, Anderson & Stowe ("WCAS"), a private equity investment firm and Windstream shareholder. The transaction will be effected pursuant to the terms of a Share Exchange Agreement (the "Share Exchange Agreement") entered into among Windstream and Welsh, Carson, Anderson & Stowe VIII, L.P., a Delaware limited partnership; Welsh, Carson, Anderson & Stowe IX, L.P., a Delaware limited partnership; WCAS Capital Partners III, L.P., a Delaware limited partnership; Regatta Holding I, L.P., a Delaware limited partnership; Regatta Holding II, L.P., a Delaware limited partnership; and Regatta Holding III, L.P., a Delaware limited partnership (each a "WCAS Sub" and together the "WCAS Subs"). Anthony J. de Nicola, a WCAS partner, was a member of both the Valor and Windstream Board of Directors through the announcement of this transaction, at which time he resigned.

Prior to completing the transaction, Windstream will contribute the Publishing Business to a newly formed subsidiary ("Holdings"). Holdings will then pay a special dividend to Windstream in an amount equal to Windstream's tax basis in the Publishing Business (currently estimated to be approximately \$30.0 million), issue additional shares of Holdings common stock to Windstream, and distribute to Windstream certain debt securities of Holdings having an aggregate principal amount of approximately \$250.0 million less the amount of the special dividend. Windstream expects to exchange the Holdings debt securities for outstanding Windstream debt with an equivalent fair market value and then retire that Windstream debt. Windstream also intends to use the proceeds of the special dividend to retire Windstream debt or repurchase Windstream equity. Following the completion of these transactions, Windstream will exchange all of the outstanding equity of Holdings (the "Holdings Shares") for an aggregate of 19,574,422 shares of Windstream common stock (the "Exchanged WIN Shares"), which will then be retired. At the time of signing, the WCAS shares were valued at approximately \$275.0 million based on a trailing average of Windstream's stock price of \$14.02 at that time. Given the value of the stock at the time of signing, the total value of the transaction was approximately \$525.0 million. Based on the four day trailing average of Windstream common stock at February 23, 2007 of \$15.05, the Exchanged WIN shares have a value of approximately \$295.0 million, increasing the expected total value of the transaction to approximately \$545.0 million.

In order to comply with the covenants in Windstream's debt instruments, subject to the terms and conditions of the Share Exchange Agreement, Windstream will exchange 80% of the Holdings Shares for 80% of the Exchanged WIN Shares in a first-step closing that is expected to occur during the second quarter of 2007. The remaining Holdings Shares held by Windstream will be exchanged for the remaining Exchanged WIN Shares in a second-step closing that is expected to occur during the fourth quarter of 2007. The first-step closing is subject to customary conditions, including (i) expiration of the required waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, (ii) the parties having received certain private letter rulings from the Internal Revenue Service ("IRS") with respect to the tax treatment of the transactions, (iii) the receipt of customary solvency and surplus opinions by the Boards of Directors of Windstream and Holdings, and (iv) the contribution of the Publishing Business to Holdings and the exchange of Holdings debt for outstanding Windstream debt. The Company has since satisfied the requirements of the Hart-Scott-Rodino Act. The second-step closing is conditioned only on the absence of any injunction, but will not occur until Windstream is able to exchange the remaining shares in compliance with the terms of its debt instruments. The terms of the Share Exchange Agreement require the transaction to be completed by December 31, 2008.

The Share Exchange Agreement provides for a customary working capital adjustment pursuant to which the parties will make cash payments to each other to the extent that the working capital of the Publishing Business is less than or greater than a specified target working capital amount at the time of the first-step closing. The Share Exchange Agreement contains customary representations, warranties and covenants and may be terminated if, among other things, the first-step closing of the transaction has not been completed within twelve months or the IRS private letter rulings are not received. The parties have also agreed to customary indemnification for breaches of representations, warranties, covenants and other matters.

In connection with the consummation of the transactions contemplated by the Share Exchange Agreement, the parties and their affiliates will enter into certain related ancillary agreements, including a Publishing Agreement, a Billing and Collection Agreement and a Tax Sharing Agreement. Pursuant to the Publishing Agreement, Windstream will grant Windstream Yellow Pages, Inc. ("Windstream Yellow Pages"), the Windstream subsidiary that currently operates the Publishing Business, an exclusive license to publish Windstream directories. Windstream Yellow Pages will, at no charge to Windstream or its affiliates or subscribers, publish directories with respect to each Windstream service area in which Windstream or its affiliates are required to publish such directories by applicable law, tariff or contract. Subject to the termination provisions in the agreement, the Publishing Agreement will remain in effect for a term of fifty years. As part of this agreement, Windstream agreed

Table of Contents

to forego future royalty payments from Windstream Yellow Pages on advertising revenues generated from its directories for the duration of the Publishing Agreement. In conjunction with the Publishing Agreement, the Company has entered into an at-market executory contract to purchase minimum advertising in its directories for a period of three years, with a renewal option for two additional years available to WCAS.

Discontinuance of the Application of SFAS No. 71 "Accounting for the Effects of Certain Types of Regulation"

Historically, the Company's Incumbent Local Exchange Carrier ("ILEC") operations, except for certain operations acquired in Kentucky in 2002 and in Nebraska in 1999, followed the accounting for regulated enterprises prescribed by SFAS No. 71. This accounting recognizes the economic effects of rate regulation by recording costs and a return on investment as such amounts are recovered through rates authorized by regulatory authorities. Recent changes, however, have impacted the dynamics of Windstream's business environment. Specifically, on July 12, 2006, the Company transitioned its Kentucky intrastate operations, which were historically subject to rate-of-return regulation, to a newly established alternative form of regulation. In addition, on July 17, 2006, Windstream announced its completion of the spin-off of Alltel Corporation's wireline business and merger with Valor, as discussed above. The former Valor properties are primarily subject to alternative price cap regulation. Accordingly, we have considered the change in the mix of our customer and revenue base from rate-of-return to an alternative form of regulation resulting from increased competition in our current assessment of criteria for the continued application of SFAS No. 71.

Additionally, we are experiencing access line losses due to increasing levels of competition across all Windstream service areas. This competition is driven largely by the technological development of alternative voice providers including wireless, cable, Voice over Internet Protocol ("VoIP"), and Competitive Local Exchange Carriers. These alternative voice products have transformed a pricing structure historically based on the recovery of costs to a pricing structure based on market conditions, including the bundling of services and discounts.

Based on these material factors impacting its operations, Windstream determined in the third quarter 2006, that it is no longer appropriate to continue the application of SFAS No. 71 for reporting its financial results. Accordingly, Windstream recorded a non-cash extraordinary gain of \$99.7 million, net of taxes of \$74.5 million, upon discontinuance of the provisions of SFAS No. 71, as required by the provisions of SFAS No. 101, "Regulated Enterprises – Accounting for the Discontinuance of the Application of FASB Statement No. 71." In addition, during the third quarter of 2006, Windstream began eliminating all intercompany revenues and related expenses. Previously, certain intercompany revenues and expenses earned and incurred by the Company's regulated subsidiaries were not eliminated because they were priced in accordance with Federal Communication Commission guidelines and were recovered through the regulatory process.

Adoption of Accounting Standards

As of December 31, 2006, the Company adopted the provisions of SFAS No. 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132 (R)". The guidance of SFAS No. 158 requires us to recognize on our consolidated balance sheet the over-funded or under-funded amount of our defined benefit postretirement plans. This amount is defined as the difference between the fair value of plan assets and the benefit obligation. We are also required to recognize as a component of accumulated other comprehensive income, net of taxes, the actuarial gains and losses and the prior service costs and credits have arisen but were not previously required to be recognized as components of net periodic benefit cost. Accumulated other comprehensive income is then adjusted as these amounts are later recognized into income as components of net periodic benefit cost. The adoption of SFAS No. 158 resulted in a reduction of our prepaid pension assets of \$103.2 million, an increase in our liability for pension and other postretirement benefits of \$106.1 million, a reduction in deferred taxes of \$82.1 million and a reduction of accumulated other comprehensive income of \$127.2 million. See Note 8, "Employee Benefit Plans and Postretirement Benefits", for further details on the amounts reflected in our consolidated balance sheets.

On January 1, 2006, the Company adopted SFAS No. 123(R), "Share-Based Payment", which is a revision of SFAS No. 123 and supercedes APB Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be valued at fair value on the date of grant, and to be expensed over the applicable vesting period. In addition, companies must also recognize compensation expense related to any awards that are not fully vested as of the effective date.

Compensation expense for the unvested awards is measured based on the fair value of the awards previously calculated in developing the pro forma disclosures in accordance with the provisions of SFAS No. 123. Upon adoption of the standard, the Company followed the modified prospective transition method and valued its

share-based payment transactions using a Black-Scholes valuation model. Under the modified prospective transition method, the Company recognizes compensation cost in its consolidated financial statements for all awards granted after January 1, 2006 and for all existing awards for which the requisite service has not been rendered as of the date of adoption. The adoption of SFAS No. 123(R) did not have a material impact on net income in 2006.

During the fourth quarter of 2005, the Company adopted FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"). The Company evaluated the effects of FIN 47 on its operations and determined that, for certain buildings containing asbestos, the Company is legally obligated to remediate the asbestos if the Company were to abandon, sell or otherwise dispose of the buildings. In addition, the Company is legally obligated to properly dispose of its chemically-treated telephone poles at the time they are removed from service. In accordance with federal and state regulations, depreciation expense for the Company's wireline operations that followed the accounting prescribed by SFAS No. 71 historically included an additional provision for cost of removal, and accordingly, the adoption of FIN 47 had no impact to these operations until the Company discontinued the application of SFAS No. 71 in the third quarter of 2006. The cumulative effect of this accounting change in 2005 resulted in a non-cash charge of \$7.4 million, net of income tax benefit of \$4.6 million, and was included in net income for the year ended December 31, 2005.

CONSOLIDATED RESULTS OF OPERATIONS

(In millions, except per share amounts)	2006	2005	2004
Revenues and sales:			
Service revenues	\$ 2,633.6	\$ 2,463.6	\$ 2,533.5
Product sales	399.7	459.9	400.0
Total revenues and sales	<u>3,033.3</u>	<u>2,923.5</u>	<u>2,933.5</u>
Costs and expenses:			
Cost of services	858.4	796.1	813.7
Cost of products sold	281.8	374.8	333.8
Selling, general, administrative and other	365.7	340.1	327.9
Depreciation and amortization	449.6	474.2	508.5
Royalty expense to Alltel	129.6	268.8	270.2
Restructuring and other charges	49.4	35.7	11.8
Total costs and expenses	<u>2,134.5</u>	<u>2,289.7</u>	<u>2,265.9</u>
Operating income	898.8	633.8	667.6
Other income, net	8.7	11.6	13.7
Loss on extinguishment of debt	(7.9)	—	—
Intercompany interest income (expense)	31.9	23.3	(15.2)
Interest expense	(209.6)	(19.1)	(20.4)
Income before income taxes, extraordinary item and cumulative effect of accounting change	<u>721.9</u>	<u>649.6</u>	<u>645.7</u>
Income taxes	276.3	267.9	259.4
Income before extraordinary item and cumulative effect of accounting change	445.6	381.7	386.3
Extraordinary item, net of income taxes	99.7	—	—
Cumulative effect of accounting change, net of taxes	—	(7.4)	—
Net income	<u>\$ 545.3</u>	<u>\$ 374.3</u>	<u>\$ 386.3</u>
Earnings per share:			
Basic:			
Income before extraordinary item and cumulative effect of accounting change	\$ 1.02	\$.95	\$.96
Extraordinary item	.23	—	—
Cumulative effect of accounting change	—	(.02)	—
Net income	<u>\$ 1.25</u>	<u>\$.93</u>	<u>\$.96</u>
Diluted:			
Income before extraordinary item and cumulative effect of accounting change	\$ 1.02	\$.95	\$.96
Extraordinary item	.23	—	—
Cumulative effect of accounting change	—	(.02)	—
Net income	<u>\$ 1.25</u>	<u>\$.93</u>	<u>\$.96</u>

Total revenues and sales increased \$109.8 million, or 4 percent, in 2006 and decreased less than 1 percent in 2005. Service revenues increased by \$170.0 million or 7 percent in 2006. The acquisition of Valor accounted for a \$222.3 million increase in service revenues in 2006. Eliminations of intercompany service revenues increased by \$25.7 million in 2006, primarily due to the discontinued application of SFAS No. 71 as previously discussed. Wireline local access service and network access and toll revenues decreased \$71.9 million in 2006 and \$78.1 million in 2005, primarily as a result of the loss of wireline access lines due, in part, to fixed-line competition and wireless substitution. In addition, local service revenues declined \$14.1 million in 2006 due to customers migrating from expanded calling area rate plans to packaged and unlimited long distance plans. Also, during 2006 Universal Service Fund ("USF") revenues declined \$15.4 million due to an increase in the national average cost per loop, combined with Windstream's cost control measures, as further discussed below in "Results of Operations by Business Segment." Telecommunications information services revenues also decreased \$8.4 million and \$24.6 million in 2006 and 2005, respectively, due to the loss of billings earned from Valor, which represented the Company's only remaining unaffiliated customer prior to the merger with Valor, and the loss of one of the Company's remaining unaffiliated wireline services customers during the fourth quarter of 2004. Finally, service revenues in 2005 reflected a decrease in advertising revenues earned from directories published in Windstream's regulated markets of \$12.2 million due to a change in the number and mix of directories published.

Partially offsetting the decline in service revenues attributable to local access service, network access and toll revenues, USF revenues and revenues derived from telecommunications information services were increases in revenues derived from broadband and other data services of \$50.6 million in 2006 and \$36.8 million in 2005, reflecting the growth in the Company's broadband customer base and continued customer demand for these enhanced services. The growth in service revenues in 2006 was also driven by increased long distance revenues of \$22.1 million due primarily to an increase in customer billing rates in all markets and the introduction of new packaged and unlimited rate plans in certain markets. Also, during 2006, Windstream received \$9.5 million in commission revenues in conjunction with offering DISH Network digital satellite television service to our residential customers. In addition, during the third quarter of 2006, Windstream began providing certain network management services to Alltel pursuant to multi-year contracts, which resulted in the recognition of revenues of \$9.8 million during 2006. During 2005, universal service fund ("USF") revenues increased \$12.5 million as a result of the decline in subscriber access revenues previously discussed.

Product sales decreased \$60.2 million, or 13 percent, in 2006, and increased \$59.9 million, or 15 percent, in 2005. The acquisition of Valor accounted for a \$2.4 million increase in product sales in 2006. The decrease in product sales was primarily driven by the increase in intercompany eliminations due to the discontinuance of the application of SFAS No. 71 during the third quarter of 2006 as previously discussed. This change in accounting policy resulted in a reduction in consolidated product sales of approximately \$81.6 million in 2006. This decrease was partially offset by an increase in sales of telecommunications equipment and data products to the Company's regulated wireline operations during periods prior to the discontinuance of the application of SFAS No. 71. It was also offset by an increase in sales to external customers of \$10.1 million due primarily to increases in sales to contractors and solid demand among smaller telecommunications providers. The increase in product sales in 2005 was due primarily to an increase in sales of telecommunications equipment and data products of \$50.4 million related to increased capital expenditures by Windstream's wireline operations.

Cost of services, which represents the cost of provisioning service, as well as business taxes and bad debt expense, increased \$62.3 million, or 8 percent, in 2006, and decreased \$17.6 million, or 2 percent, in 2005. The acquisition of Valor accounted for a \$67.8 million increase in cost of services in 2006. During 2006, the Company's wireline operations incurred additional costs from other carriers for transport and termination of intrastate traffic in accordance with the terms of new agreements negotiated with those carriers during 2005, as well as incremental interconnection expense related to network management services provided to Alltel in periods following the spin-off. Partially offsetting these increases in cost of services was an increase in intercompany eliminations due to the discontinuance of the application of SFAS No. 71 during the third quarter of 2006 as previously discussed. In addition, bad debt expense declined in 2006 by \$11.3 million, which was primarily due to the declines in revenue previously discussed, improvements in our overall collection efforts, and the sale in December 2006 of certain customer receivables of approximately \$3.8 million, previously determined to be uncollectible. The 2005 decrease was driven primarily by a reduction in costs incurred by the telecommunications information services operations due to the loss of a customer as discussed herein.

Cost of products sold decreased \$93.0 million, or 25 percent in 2006. The decline in cost of products sold is consistent with the decline in product sales discussed above and was due primarily to the increase in intercompany eliminations caused by the discontinuance of the application of SFAS No. 71. Cost of products sold increased \$41.0 million, or 12 percent, in 2005, consistent with the increase in product sales discussed above.

Selling, general, administrative and other expenses increased \$25.6 million, or 8 percent, in 2006 and \$12.2 million, or 4 percent, in 2005. The acquisition of Valor accounted for a \$21.8 million increase in selling, general, administrative and other expenses in 2006. Selling, general, administrative and other expenses in 2006 were affected by the decline in allocations received from Alltel related to services that Alltel provided for the Company for periods prior to the spin-off under a shared services arrangement, partially offset by a gradual increase in direct expenses associated with Windstream's new corporate cost structure. The 2005 increase was due primarily to increased selling and marketing costs incurred by Windstream's publishing subsidiary.

Depreciation and amortization expense declined \$24.6 million, or 5 percent, and \$34.3 million, or 7 percent, in 2006 and 2005, respectively. The acquisition of Valor accounted for a \$56.4 million increase in depreciation and amortization expense in 2006. The decline primarily resulted from a reduction in depreciation rates for certain of the Company's wireline operations, reflecting the results of studies of depreciable lives completed during 2006 and 2005.

Royalty expense to Alltel declined \$139.2 million, or 52 percent, and \$1.4 million or 1 percent, in 2006 and 2005, respectively.

Windstream's ILEC subsidiaries incurred a royalty expense from Alltel for the use of the Alltel brand name in marketing and distributing telecommunications products and services pursuant to a licensing agreement with an Alltel affiliate. Following the spin-off and merger with Valor, Windstream no longer incurs this charge as it discontinued use of the Alltel brand name following a brief transitional rebranding period.

Restructuring and Other Charges

A summary of the restructuring and other charges recorded in 2006 was as follows:

(Millions)	Wireline	Product Distribution	Other Operations	Total
Fees associated with spin-off from Alltel	\$ 7.9	\$ —	\$ —	\$ 7.9
Signage and other rebranding costs related to the spin-off	13.8	—	—	13.8
Severance and employee benefit costs	10.5	0.1	—	10.6
Costs associated with split-off of directory publishing	—	—	11.2	11.2
Computer system separation and conversion costs	5.9	—	—	5.9
Total restructuring and other charges	\$ 38.1	\$ 0.1	\$ 11.2	\$ 49.4

During 2006, the Company incurred \$27.6 million of costs in connection with its spin-off from Alltel and merger with Valor. These costs consisted of \$7.9 million of consulting and legal fees, \$13.8 million of signage and other costs to rebrand the Company's offices and vehicles, and \$5.9 million of computer system separation and conversion costs. Of these charges, \$26.6 million was paid in cash during the year, and \$0.8 million related to a non-cash adjustment of compensation expense relating to the accelerated vesting of employees' Alltel restricted stock pursuant to the spin-off. The remaining liability of \$0.2 million will be funded through operating cash flows and paid during 2007.

In the fourth quarter of 2006, the Company announced a realignment of its operational functions to better serve customers and operate more efficiently. These changes will result in the elimination of approximately 180 net employee positions during the first half of 2007. In connection with these activities, the Company recorded a restructuring charge of \$10.6 million consisting of severance and employee benefits related to this planned workforce reduction. Payments pursuant to the plan will be made during the first half of 2007 as positions are eliminated and will be funded through operating cash flows. As a result of the consolidation of certain functions and the standardization of processes, the Company expects to realize annual savings of approximately \$15.0 million – \$20 million beginning in 2008.

On December 12, 2006 Windstream announced that it would split off its directory publishing business in what Windstream expects to be a tax-free transaction with entities affiliated with Welsh, Carson, Andersen and Stowe, a private equity investment firm (see Note 17 to the accompanying consolidated financial statements for additional information regarding this pending transaction). In conjunction with this transaction, the Company incurred \$11.2 million of incremental costs, primarily consisting of investment banker, audit and legal fees in the fourth quarter of 2006, of which \$1.8 million had been paid by the end of the year. The remaining fees will be paid pursuant to the closing of the transaction in 2007 and will be funded through operating cash flows.

A summary of the restructuring and other charges recorded by our wireline operations in 2005 was as follows:

(Millions)

Severance and employee benefit costs	\$ 4.5
Fees associated with spin-off and merger of wireline operations	31.2
Total restructuring and other charges	\$ 35.7

During the third quarter of 2005, the Company incurred \$4.7 million of severance and employee benefit costs related to a planned workforce reduction in its wireline operations. In the fourth quarter of 2005, the Company reduced the liabilities associated with the wireline restructuring activities by \$0.2 million to reflect differences between estimated and actual costs paid in completing the employee terminations. As of December 31, 2005, Windstream had paid \$4.5 million in severance and employee-related expenses, and all of the employee reductions had been completed. In connection with the spin-off from Alltel and merger with Valor, the Company incurred \$31.2 million of incremental costs during the fourth quarter of 2005, principally representing accrued investment banker, audit and legal fees, which were paid through advances from Alltel.

A summary of the restructuring and other charges recorded in 2004 was as follows:

(Millions)	Wireline	Product Distribution	Other Operations	Total
Severance and employee benefit costs	\$ 11.2	\$ 0.1	\$ 0.3	\$ 11.6
Relocation costs	1.2	—	0.1	1.3
Lease and contract termination costs	(1.8)	—	—	(1.8)
Other exit costs	0.7	—	—	0.7
Total restructuring and other charges	\$ 11.3	\$ 0.1	\$ 0.4	\$ 11.8

In January 2004, the Company announced plans to reorganize its operations and support teams. Also during February 2004, the Company announced plans to exit its competitive local exchange carrier operations in the Jacksonville, Florida market due to the continued unprofitability of these operations. In connection with these activities, the Company recorded a restructuring charge of \$13.6 million, consisting of \$11.6 million in severance and employee benefit costs related to a planned workforce reduction, \$1.3 million of employee relocation expenses and \$0.7 million of other exit costs. As of December 31, 2005, the Company had paid all of the severance and employee-related expenses, and all of the employee reductions and relocations had been completed. During 2004, the Company also recorded a \$1.8 million reduction in the liabilities associated with various restructuring activities initiated prior to 2003, consisting of lease and contract termination costs. The reductions primarily reflected differences between estimated and actual costs paid in completing the lease and contract terminations.

Restructuring and other charges decreased net income \$36.0 million, \$34.1 million and \$7.3 million for the years ended December 31, 2006, 2005 and 2004, respectively, giving consideration to tax benefits on deductible items. The restructuring and other charges discussed above were not allocated to our business segments, as management evaluates segment performance excluding the effects of these items. See Note 10 to the accompanying consolidated financial statements for additional information regarding these charges.

Other Income, Net

Other income, net decreased \$2.9 million, or 25 percent, in 2006 and decreased \$2.1 million, or 15 percent, in 2005. The decrease in other income in 2006 primarily resulted from a decrease in the amount of annual dividends paid on our investment in Rural Telephone Bank Class C stock. As of December 31, 2005, our investment in Rural Telephone Bank Class C stock was transferred to Alltel. As a result, we did not receive any related dividends during 2006. This decline in 2006 was partially offset by a \$7.4 million increase in interest income earned on cash and short-term investments, which totaled \$386.8 million at December 31, 2006.

Loss on Extinguishment of Debt

In conjunction with the spin-off from Alltel, as previously discussed, the Company repaid a portion of the long-term debt that had been issued by certain of the Company's wireline subsidiaries. As a result, the Company incurred debt prepayment penalties of \$7.9 million in 2006.

Intercompany Interest Income (Expense)

Prior to the spin-off from Alltel, the Company participated in a centralized cash management program with its parent company. Under this program, the Company earned interest on amounts remitted to Alltel at a rate based on current

market rates for short-term investments and paid interest on amounts received from Alltel at a rate based on Alltel's weighted-average borrowing rate. Intercompany interest income increased \$8.6 million and \$38.5 million in 2006 and 2005, respectively. The increase in both periods is primarily due to an increase in the amount of funds remitted to Alltel under the cash management program, combined with an increase in the advance interest rate. The Company has canceled its participation in the cash management program following the spin-off from Alltel.

Interest Expense

Interest expense increased \$190.5 million, or 997 percent, in 2006 and decreased \$1.3 million, or 6 percent, in 2005. As previously discussed, in conjunction with the spin-off from Alltel and merger with Valor, the Company borrowed approximately \$4.9 billion of long-term debt under a credit facility and through the issuance of senior notes, and assumed \$400.0 million principal value of additional senior notes from Valor. These borrowings, along with \$181.0 million of debt issued by the Company's wireline operating subsidiaries, resulted in approximately \$5.5 billion of long-term debt at December 31, 2006. The weighted-average interest rate paid on the long-term debt in periods following the spin-off and merger was 7.8 percent.

Income Taxes

Income tax expense increased 3 percent in both 2006 and 2005, or \$8.4 million and \$8.5 million, respectively. The increase in income tax expense in 2006 is due to the increase in income before income taxes, partially offset by a settlement received from the Internal Revenue Service ("IRS") during 2006 related to taxes paid during 1997 through 2003. The increase in income tax expense in 2005 was due primarily to the non-deductible expenses incurred related to the spin-off, as previously discussed. The Company's effective tax rate in 2006 was 38.3 percent, compared to 41.3 percent in 2005 and 40.2 percent in 2004. For 2007, the Company's effective income tax rate is expected to range between 39.0 and 41.0 percent. Changes in the relative profitability of our operation segments, as well as recent and proposed changes to federal and state tax laws may cause the rate to change from historical rates. See Note 12, "Income Taxes", to the accompanying consolidated financial statements for further discussion of income tax expense and deferred taxes.

Extraordinary Item

As previously discussed, during the third quarter of 2006, Windstream discontinued the application of SFAS No. 71. Pursuant to the guidance in SFAS No. 101, "Discontinuation of the Application of FASB Statement No. 71," the impact of discontinuing the application of SFAS No. 71 was recognized as an extraordinary gain, net of taxes. See Note 3, "Accounting Changes", to the accompanying consolidated financial statements for further discussion of the components of this gain.

Cumulative Effect of Accounting Change

During the fourth quarter of 2005, we adopted FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"), which is an interpretation of SFAS No. 143, "Accounting for Asset Retirement Obligations". SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development, or normal use of the assets. SFAS No. 143 requires that a liability for an asset retirement obligation be recognized when incurred and reasonably estimable, recorded at fair value and classified as a liability in the balance sheet. When the liability is initially recorded, the entity capitalizes the cost and increases the carrying value of the related long-lived asset. The liability is then accreted to its present value each period, and the capitalized cost is depreciated over the estimated useful life of the related asset. At the settlement date, the entity will settle the obligation for its recorded amount and recognize a gain or loss upon settlement. FIN 47 states that the accounting guidance in SFAS No. 143 is applicable to asset retirement obligations that are conditional on the occurrence of a future event.

We evaluated the effects of FIN 47 on our operations and determined that, for certain buildings containing asbestos, we are legally obligated to remediate the asbestos if we were to abandon, sell or otherwise dispose of the buildings. In addition, we are legally obligated to properly dispose of our chemically-treated telephone poles at the time they are removed from service. In accordance with federal and state regulations, depreciation expense for our ILEC operations that followed the accounting prescribed by SFAS No. 71 have historically included an additional provision for cost of removal, and accordingly, the adoption of FIN 47 had no impact on these operations. The cumulative effect of this change resulted in a non-cash charge of \$7.4 million, net of income tax benefit of \$4.6 million, and was included in net income for the year ended December 31, 2005. Upon discontinuance of the provisions of SFAS No. 71, as previously discussed, the provisions for FIN 47 were also applied to chemically-treated telephone poles in the Company's other wireline operations. The impact of applying the provisions of FIN 47 is included in the non-cash extraordinary gain previously discussed.

Weighted Average Common Shares Outstanding

The weighted average number of common shares outstanding increased 8 percent in 2006. The increase in 2006 primarily reflects a partial year impact of the additional 70.9 million common shares assumed through the merger with Valor on July 17, 2006. Common shares in historical periods totaled 402.9 million and represented the shares issued to Alltel shareholders pursuant to the spin-off of the Alltel wireline division.

RESULTS OF OPERATIONS BY BUSINESS SEGMENT**Wireline Operations**

(Millions, access lines and long distance customers in thousands)	2006	2005	2004
Revenues and sales:			
Local service	\$ 1,094.8	\$ 1,081.5	\$ 1,115.6
Network access and interconnection	1,137.6	1,034.1	1,038.3
Long distance	219.0	180.4	174.1
Miscellaneous	307.2	255.8	256.9
Total revenues and sales	<u>2,758.6</u>	<u>2,551.8</u>	<u>2,584.9</u>
Costs and expenses:			
Cost of services	893.3	825.0	824.0
Cost of products sold	36.7	31.7	29.4
Selling, general, administrative and other	322.2	302.4	301.2
Depreciation and amortization	446.0	470.2	504.0
Royalty expense to Alltel	129.6	268.8	270.2
Total costs and expenses	<u>1,827.8</u>	<u>1,898.1</u>	<u>1,928.8</u>
Segment income	\$ 930.8	\$ 653.7	\$ 656.1
Access lines in service (excludes broadband lines)	3,242.9	2,885.7	3,009.4
Average access lines in service	3,053.3	2,950.0	3,061.5
Average revenue per customer per month (a)	\$ 75.29	\$ 72.08	\$ 70.36
Long distance customers	1,991.0	1,750.8	1,770.8

Notes:

(a) Average revenue per customer per month is calculated by dividing total wireline revenues by average access lines in service for the period.

Wireline operations consists of the Company's retail and wholesale telecommunications services, including local, long distance, broadband, and network access. Wireline revenues and sales increased \$206.8 million, or 8 percent, in 2006 and decreased \$33.1 million or 1 percent in 2005. The acquisition of Valor accounted for a \$222.3 million increase in wireline revenues and sales in 2006. Customer access lines increased 12 percent in 2006, reflecting the addition of the Valor operations, partially offset by declines in both primary and secondary access lines. The Company lost approximately 138,000 and 124,000 access lines during 2006 and 2005, respectively, primarily resulting from the effects of fixed line competition and wireless substitution, and the Company expects access lines to continue to be impacted by these effects in 2007.

To slow the decline of revenue in 2007, we will continue to emphasize sales of enhanced services and bundling of our various product offerings including broadband, voice and digital satellite television. Deployment of broadband service is a strategic imperative for the Company, and as of December 31, 2006, approximately 77 percent of our addressable lines were broadband-capable compared to approximately 73 percent for the same period in 2005. During 2006 and 2005, we added approximately 258,000 and 154,000 broadband customers, respectively, including 67,000 acquired during 2006 from Valor, increasing our broadband customer base to over 656,000 customers, which represents a penetration rate of 20 percent of access lines in service as of December 31, 2006. The growth in the Company's broadband customers more than offset the decline in customer access lines noted above. As a result, and as further discussed below, revenues generated from the sales of data services increased during 2006, which partially offset the adverse effects on wireline revenues resulting from the loss of access lines. In addition, during the fourth quarter of 2005, we began offering DISH Network digital satellite television service to our residential customers as part of a bundled product offering. Our partnership with DISH Network is also an important strategic initiative for the Company, as it allows us to provide a full suite of telecommunications and entertainment services to our customers on one integrated bill.

Local service revenues consist of local exchange telephone services provided to both residential and business customers, including monthly recurring charges for basic services such as local dial-tone and enhanced services such as caller identification, voicemail and call waiting, and non-recurring charges for service activation and reconnection of service. Local service revenues increased \$13.3 million, or 1 percent, in 2006 and decreased \$34.1 million, or 3 percent, in 2005. The acquisition of Valor accounted for a \$68.5 million increase in local service revenues in 2006.

Local service revenues in both periods primarily reflected reductions consistent with the overall decline in access lines discussed above. In addition, the decline in local service revenues in 2006 reflected reductions in expanded calling area rate plans of \$14.1 million. As further discussed below, the Company has begun offering new long distance rate plans in select markets, which has induced customers to move from expanded calling areas to unlimited long distance calling and has resulted in increases in long distance revenues. The decline in local service revenues in 2006 was also the result of discounts provided to customers who elected a bundle of services. These discounts are applied to non-regulated features included in the package such as voice mail and caller identification. Conversely, the decline in local service revenues in 2005 attributable to access line loss was partially offset by growth in revenues derived from the sales of those features and equipment protection plans. Revenues from these services increased \$3.6 million in 2005, reflecting continued demand for these products and services.

Network access and interconnection revenues include switched access, special access, end user charges and receipts from federal and state USF. Switched access represents usage sensitive charges to long distance companies for access to our network in connection with the completion of interstate and intrastate long distance calls. Special access represents dedicated circuits, including circuits used to provide broadband service, while end user charges are monthly flat-rate charges assessed on access lines. Network access and interconnection revenues increased \$103.5 million, or 10 percent in 2006, and decreased slightly in 2005. The acquisition of Valor accounted for a \$119.6 million increase in network access and interconnection revenues in 2006. Primarily due to the overall decline in access lines discussed above, network access usage and toll revenues decreased \$30.7 million in 2006 and \$42.8 million in 2005. Partially offsetting the decline in network access and interconnection revenues in both periods due to access line loss was the growth in revenues earned from data services, which increased \$30.1 million and \$26.0 million in 2006 and 2005, respectively. The growth in revenues from data services in both 2006 and 2005 primarily reflected increased demand for high-speed data transport services. In addition to the effects of access line loss and increased demand for data services, federal and state USF funding decreased \$15.4 million in 2006 and increased \$12.5 million in 2005, respectively. Windstream receives both federal and state USF subsidies due to the rural nature of most of its regulated markets. The decrease in USF revenues in 2006 resulted primarily from a decrease in the high-cost loop support ("HCLS") funding received by our regulated subsidiaries. The decreases in HCLS funding primarily resulted from increases in the national average cost per loop combined with the effects of our cost control efforts. Receipts from the ICLS fund are based on a comparison of each company's embedded cost per loop to a national average cost per loop. Primarily due to expected increases in the national average cost per loop and our continued focus on controlling operating costs in our regulated business, we expect net federal and state USF receipts in 2007 to decline by approximately \$15.0 million, compared to 2006. The increase in USF revenues in 2005 resulted primarily from an increase of \$13.3 million in interstate common line support ("ICLS") funding received in our rate-of-return markets as a result of the declining subscriber access revenues discussed above. ICLS funding is intended to ensure that rate-of-return carriers receive sufficient revenues to earn an appropriate profit margin, defined as 11.25 percent of eligible costs.

Long distance revenues primarily consist of per minute and recurring charges for placing interstate and intrastate long distance calls. Revenues derived from long distance services increased \$38.6 million, or 21 percent, in 2006. The acquisition of Valor accounted for a \$16.6 million increase in long distance revenues in 2006. The increase was primarily driven by new rate plans initiated in various markets during 2006 that provide packages of minutes or unlimited minutes of long distance services for a flat monthly recurring charge and an increase in customer billing rates in all markets initiated during October 2006. In response to competitive pressures, the Company continues to introduce long distance rate plans in its markets that provide customers with various billing options. Revenues attributable to long distance services increased \$6.3 million, or 4 percent, in 2005, primarily due to an increase in customer billing rates initiated during the second quarter of 2005 on one of our most popular billing plans. In both years, the increases were partially offset by a decline in usage charges resulting from the effects of customers migrating to the packaged rate plans previously discussed. Miscellaneous revenues primarily consist of charges for the non-regulated portion of broadband services, directory advertising, customer premise equipment sales and rentals, billing and collection services provided to long distance

companies and commissions earned from activations of digital satellite television service. Miscellaneous revenues increased \$51.4 million, or 20 percent, in 2006 and decreased slightly in 2005. The acquisition of Valor accounted for a \$17.6 million increase in miscellaneous revenues in 2006. Primarily driven by growth in broadband customers, revenues from broadband services increased \$20.5 million in 2006 and \$10.8 million in 2005. In addition, sales and rentals of customer premise equipment increased \$3.4 million in 2005, reflecting continued customer demand for these products. In 2006, sales and rentals of customer premise equipment also included \$1.5 million related to sales of broadband modems. During October 2006, Windstream began selling broadband modems to customers subject to a rebate offer. The rebate offer is for a fixed amount per modem and expires after 45 days if not claimed by the customer. Modem sales revenues recognized during 2006 pursuant to the rebate program have been reduced by the portion of rebates expected to be claimed by customers. Also, we generated \$9.5 million and \$1.1 million in commissions revenue in 2006 and 2005, respectively, in conjunction with offering DISH Network digital satellite television service to our residential customers as discussed above. In addition, during the third quarter of 2006, Windstream began providing certain network management services to Alltel pursuant to multi-year contracts entered into as part of the separation, which resulted in the recognition of revenues of \$9.8 million during 2006. Offsetting these increases in miscellaneous revenues in 2005 were decreases in directory advertising revenues of \$12.2 million, primarily due to a change in the number and mix of directories published during the period.

Primarily due to the broadband customer growth and increased long distance revenues, average revenue per customer per month increased 4 percent in 2006. The growth in broadband customers and increased sales of enhanced features in 2005 resulted in growth in average revenue per customer per month of 2 percent compared to the corresponding prior year period. Future growth in average revenue per customer per month will depend on our success in sustaining growth in sales of broadband and other enhanced services to new and existing customers.

Cost of services increased \$68.3 million, or 8 percent, in 2006 and increased slightly in 2005. The acquisition of Valor accounted for a \$67.8 million increase in cost of services in 2006. Cost of services in 2006 included a decrease in bad debt expense of \$7.5 million consistent with the decline in revenues discussed above and improvements in the collection rates. In addition, during December 2006, Windstream sold certain customer receivables that had been deemed uncollectible to a third party collection agency for \$3.8 million, which was reflected as a reduction in bad debt expense. Also, cost of services declined in 2006 due to decreases in costs associated with providing broadband-capable modems to new broadband customers driven by volume discounts earned by the Company. In addition, because the Company began selling broadband modems to its customers, subject to a rebate offer as discussed above, during October 2006, Windstream began classifying costs associated with broadband-capable modems as costs of products sold. Conversely, interconnection expenses increased \$15.4 million in 2006. These increases were primarily due to additional costs charged by other carriers for transport and termination of intrastate traffic in accordance with the terms of new agreements negotiated with these carriers that took effect during 2005, as well as increased transport costs associated with the growth in broadband customers and long distance minutes of use due to increases in package rate plans previously discussed. In addition, interconnection expenses increased \$5.6 million in 2006 due to incremental expenses incurred in the provision of network management services to Alltel as previously discussed.

Cost of services for 2005 included approximately \$3.2 million of incremental costs incurred during the first quarter of 2005 related to work force reductions in our wireline business, as well as higher overtime and maintenance costs due to inclement weather. Cost of services in 2005 also included \$4.4 million of additional customer service expenses attributable to the growth in broadband customers, specifically the costs associated with subsidizing broadband-capable modems to new broadband customers. In addition, cost of services in 2005 included increased regulatory fees of \$5.6 million related to an increase in the contribution factor applicable to universal service funding, which was collected from our customers. Offsetting the increase in overtime expense, customer service costs and regulatory fees in 2005 was a decrease in business taxes of \$6.3 million and a decrease in bad debt expense of \$4.4 million, both consistent with the decline in revenues discussed above.

Cost of products sold increased \$5.0 million, or 16 percent, in 2006 and increased \$2.3 million, or 8 percent, in 2005. The increase in 2006 primarily resulted from the classification of costs associated with sales of broadband-capable modems as cost of products sold beginning in October 2006, as previously discussed, and the acquisition of Valor. The increase in 2005 was consistent with the increase in sales and rentals of customer premise equipment discussed above.

Selling, general, administrative and other expenses increased \$19.8 million, or 7 percent, in 2006 and increased slightly in 2005. The acquisition of Valor accounted for a \$21.8 million increase in selling, general, administrative and other expenses in 2006. Selling, general, administrative and other expenses in 2006 were affected by the combination of a decline in intercompany allocations received from Alltel leading up to the separation, offset by a gradual increase in expenses associated with Windstream's new corporate cost structure. Prior to the spin, under a shared services arrangement, Alltel provided certain functions on the Company's behalf, including but not limited to accounting, marketing, customer billing, information technology, legal, human resources, and engineering services. The increase in 2005 was due primarily to higher insurance premiums related to employee medical and dental plans. Partially offsetting the increase in employee benefit costs in 2005 was a decline in intercompany allocations received from Alltel.

Depreciation and amortization expense decreased \$24.2 million, or 5 percent, in 2006 and \$33.8 million, or 7 percent, in 2005. The acquisition of Valor accounted for a \$56.4 million increase in depreciation and amortization expense in 2006. The decrease in depreciation and amortization expense primarily resulted from a reduction in depreciation rates for the Company's Florida, Georgia, and South Carolina operations, reflecting the results of studies of depreciable lives completed during 2005, and for its Alabama, Arkansas, North Carolina, Pennsylvania and certain Texas operations, reflecting the results of studies completed during 2006. The depreciable lives were lengthened to reflect the estimated remaining useful lives of the wireline plant based on the Company's expected future network utilization and capital expenditure levels required to provide service to its customers. During 2007, the Company expects to review the depreciation rates utilized in certain of its remaining wireline operations.

Royalty expense decreased \$139.2 million, or 52 percent, and \$1.4 million or 1 percent, in 2006 and 2005, respectively. Prior to the separation, Windstream's regulated subsidiaries incurred a royalty expense from Alltel for the use of the Alltel brand name in marketing and distributing telecommunications products and services pursuant to a licensing agreement with an Alltel affiliate. Following the spin off and merger with Valor, Windstream no longer incurs this charge as it discontinued the use of the Alltel brand name following a brief transitional rebranding period.

Wireline segment income increased \$277.1 million, or 42 percent in 2006, and decreased slightly in 2005, or \$2.4 million. The acquisition of Valor accounted for a \$75.4 million increase in wireline segment income in 2006. The increase in segment income in 2006 primarily resulted from the termination of the licensing agreement with Alltel, the favorable effects of reduced depreciation rates and the incremental expenses associated with work force reductions and higher overtime and repair costs incurred in the first quarter of 2005, which were partially offset by the decline in revenues and sales due to the loss of access lines, as discussed above. The decrease in segment income in 2005 primarily resulted from the decline in revenues and sales due to the loss of access lines, which was partially offset by the favorable effects of reduced depreciation rates, as discussed above.

Set forth below is a summary of the restructuring and other charges related to the wireline operations that were not included in the determination of segment income for the years ended December 31:

(Millions)	2006	2005	2004
Fees associated with spin-off from Alltel	\$ 7.9	\$ 31.2	\$ —
Signage and other rebranding costs	13.8	—	—
Severance and employee benefit costs	10.5	4.5	11.2
Computer system separation and conversion costs	5.9	—	—
Lease and contract termination costs	—	—	(1.8)
Relocation costs	—	—	1.2
Other exit costs	—	—	0.7
Total restructuring and other charges	\$ 38.1	\$ 35.7	\$ 11.3

Regulatory Matters – Wireline Operations

The Company's Incumbent Local Exchange Carriers ("ILECs") are regulated by both federal and state agencies. The Company's interstate products and services and the related earnings are subject to federal regulation by the Federal Communications Commission ("FCC"), and the Company's intrastate and local services are subject to state regulation by the respective state Public Service Commissions ("PSCs"). The FCC has primary jurisdiction over

interstate switched and special network access rates and broadband service offerings. State PSCs have primary jurisdiction over matters including local service rates, intrastate switched and special network access rates, quality of service, depreciation rates, the disposition of public utility property, the issuance of securities or debt and the accounting systems used by telecommunications companies for regulatory reporting purposes.

Telecommunications Legal Reform

The Telecommunications Act of 1996 (“the 96 Act”) significantly changed and may further change the existing laws and regulations governing the telecommunications industry. The primary goal of the 96 Act was to create competition in the wireline market by requiring ILECs to sell portions of their networks to competitors at reduced wholesale rates (known as unbundled network elements). The 96 Act also established rules for interconnecting wireline and wireless service providers’ networks. Unfortunately, the 96 Act failed to contemplate the rapid evolution of technology and the associated consumer demand for wireless services and the Internet. Today, providers of communications services are regulated differently depending primarily upon the network technology used to deliver service. In an effort to reform the manner in which telecommunications service providers are regulated, bills have been introduced in Congress designed to reduce the existing level of regulation on the industry and update applicable laws governing, among other things, interconnection, inter-carrier compensation, the provision of broadband services, universal service contribution and distribution methodologies and the video franchise approval process. The prospect for federal legislation in 2007 is uncertain. Therefore the Company cannot predict the outcome of these efforts to reform regulation of the telecommunications industry or their potential impact on the business.

Federal Regulation

With the exception of the Nebraska, New Mexico and portions of the Kentucky, Oklahoma and Texas operations, the Company’s ILEC operations are subject to rate-of-return regulation by the FCC. The Nebraska, New Mexico and portions of the Kentucky, Oklahoma and Texas operations are subject to price-cap regulation by the FCC that allows a greater degree of retail pricing flexibility than is afforded to the Company’s rate-of-return regulated operations. Companies meeting certain criteria had the option to elect price-cap regulation as part of a FCC order issued in May 2000 (the “CALLS plan”). The CALLS plan expired on June 30, 2005, and to date, the FCC has not established a successor mechanism for regulating price-cap companies. Nonetheless, the existing rules and regulations for price-cap companies remain effective until the FCC modifies or otherwise replaces them with a successor mechanism.

State Regulation

The Company has elected alternative regulation for local and intrastate services provided by its ILEC subsidiaries in Alabama, Arkansas, Florida, Georgia, Kentucky, Missouri, Nebraska, New Mexico, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, and Texas. The Company continues to evaluate alternative regulation options in Mississippi and New York where the local and intrastate services provided by its ILEC subsidiaries remain subject to rate-of-return regulation.

We receive USF support in a limited number of states in which we operate. In 2006, Windstream received \$83.6 million in state universal service support excluding the support received by Valor prior to the merger. In 2007, the Company expects to receive approximately \$130 million to \$140 million in state USF support. These payments are intended to provide additional support, beyond the federal universal service receipts, for the high cost of operating in rural markets. For the year ended December 31, 2006, Windstream received approximately \$56.0 million from the Texas USF excluding the support received by Valor prior to the merger. In 2007, the Company expects to receive approximately \$100 million to \$110 million in Texas USF, including support received in the former Valor markets, for the full year.

Because certain of the regulatory matters discussed above are under FCC or judicial review, resolution of these matters continues to be uncertain, and the Company cannot predict at this time the specific effects, if any, that the 96 Act, regulatory decisions and rulemakings, and future competition will ultimately have on its ILEC operations. For a detailed discussion of our federal and state regulation, see Item 1. “Regulation” of this annual report on Form 10-K.

Product Distribution

(Millions)	2006	2005	2004
Revenues and sales:			
Product sales	\$ 334.9	\$ 307.9	\$ 257.5
Total revenues and sales	<u>334.9</u>	<u>307.9</u>	<u>257.5</u>
Costs and expenses:			
Cost of products sold	312.8	289.2	239.5
Selling, general, administrative and other	15.9	12.4	12.4
Depreciation and amortization	1.4	1.9	2.5
Total costs and expenses	<u>330.1</u>	<u>303.5</u>	<u>254.4</u>
Segment income	<u>\$ 4.8</u>	<u>\$ 4.4</u>	<u>\$ 3.1</u>

Revenues and sales from Windstream's product distribution segment are primarily derived from sales of equipment to affiliated and non-affiliated communications companies. Such revenues and sales increased \$27.0 million, or 9 percent, and \$50.4 million, or 20 percent, in 2006 and 2005, respectively. Sales of telecommunications equipment and data products to the Company's affiliated entities increased in both periods. The increase in 2006 in affiliated sales was primarily due to sales to the newly acquired Valor markets, while the increase in 2005 primarily reflected an increase in capital expenditures by Windstream's regulated wireline operations. In addition, sales to external customers increased \$10.1 million in 2006, due primarily to increases in sales to contractors and solid demand among smaller telecommunications providers. For the year ended December 31, 2006, intercompany sales were \$193.9 million, or 57.9 percent of total sales, compared to intercompany sales of \$177.0 million, or 57.5 percent of total sales, in 2005. Cost of products sold increased \$23.6 million, or 8 percent, and \$49.7 million, or 21 percent, in 2006 and 2005, respectively. The increase in both periods was consistent with the growth in revenues and sales discussed above. As a result, segment income for 2006 and 2005 was substantially unchanged compared to the prior periods.

During 2006 and 2004, restructuring and other charges in both periods amounted to \$0.1 million. These charges related to severance and employee benefit costs and were not included in segment income for the product distribution operations. There were no restructuring and other charges related to product distribution during 2005.

Other Operations

(Millions)	2006	2005	2004
Revenues and sales:			
Directory publishing	\$ 153.5	\$ 154.7	\$ 155.9
Telecommunications information services	8.8	17.2	41.8
Total revenues and sales	<u>162.3</u>	<u>171.9</u>	<u>197.7</u>
Costs and expenses:			
Cost of services	9.0	17.9	34.4
Cost of products sold	111.0	114.9	126.8
Selling, general, administrative and other	27.5	25.6	14.3
Depreciation and amortization	2.2	2.1	2.0
Total costs and expenses	<u>149.7</u>	<u>160.5</u>	<u>177.5</u>
Segment income	<u>\$ 12.6</u>	<u>\$ 11.4</u>	<u>\$ 20.2</u>

Revenues and sales from the Company's other operations are derived from revenues associated with publishing directories for affiliated and non-affiliated local exchange carriers and charges to non-affiliated telecommunications companies for information services (primarily customer billing). Revenues and sales attributable to the Company's other operations decreased \$9.6 million, or 6 percent, and \$25.8 million, or 13 percent, in 2006 and 2005, respectively.

Telecommunications information services revenues decreased \$8.4 million, or 49 percent, in 2006, due to the loss of billings earned from Valor, which represented the Company's only remaining unaffiliated customer prior to the merger with Valor. Revenues decreased \$24.6 million, or 59 percent, in 2005 due to the loss of an unaffiliated wireline service customer during the fourth quarter of 2004. Following the spin-off from Alltel and merger with Valor, the Company no longer incurs revenues or recognizes expenses for these activities. Revenues derived from the Company's directory publishing operations were relatively unchanged in 2006 and 2005 compared to the prior periods.

restricted payments, unless funded from proceeds of certain equity offerings or other sources that are not operating cash flow; (ii) certain permitted investments; (iii) payments to repay, redeem, retire or refinance any indebtedness, other than repayments of the revolving loans under the senior secured credit facilities and certain other indebtedness, unless such payments are funded from proceeds of certain equity offerings or other sources that are not operating cash flow; and (iv) capital expenditures, unless funded from proceeds of certain equity offerings or other sources that are not operating cash flow.

As previously discussed, prior to the spin-off from Alltel, the Company participated in the centralized cash management practices of Alltel. Under these practices, cash balances were transferred daily to Alltel bank accounts, and the Company obtained interim financing from Alltel to fund its daily cash requirements and invested short-term excess funds with Alltel. At December 31, 2005 the Company had a net payable to Alltel, which was included in Parent Company Investment of Alltel in the accompanying consolidated balance sheet. During 2006, the Company reduced its overall net borrowings from Alltel by \$290.3 million, compared to reductions of \$346.7 million in 2005 and \$365.9 million in 2004.

Liquidity and Capital Resources

The Company believes that it has adequate operating cash flows to finance our ongoing operating requirements, including capital expenditures, payments of interest and scheduled amortization of long-term debt and payment of dividends. As previously discussed, on July 17, 2006, Alltel completed the spin-off of its wireline telecommunications business to its stockholders and the merger of that wireline business with Valor. Pursuant to the plan of Distribution and immediately prior to the effective time of the Merger with Valor described below, Alltel contributed all of the wireline assets in exchange for: (i) newly issued Company common stock (ii) the payment of a special dividend to Alltel in an amount of \$2,275.1 million and (iii) the distribution by the Company to Alltel of certain debt securities (the "Contribution"). In connection with the Contribution, the Company assumed approximately \$261.0 million of long-term debt that had been issued by the Company's wireline operating subsidiaries. Also in connection with the Contribution the Company borrowed approximately \$2.4 billion through a new senior secured credit agreement that was used to fund the special dividend and repay \$80.8 million (plus \$7.9 million in related make-whole premiums and \$1.9 million in accrued interest) of the long-term debt assumed by the Company in the Contribution. The debt securities issued by the Company to Alltel as part of the Contribution consisted of 8.625 percent senior notes due 2016 with an aggregate principal amount of \$1,746.0 million (the "Company Securities"). The Company Securities were issued at a discount, and accordingly, at the date of their distribution to Alltel, the Company Securities had a carrying value of \$1,703.2 million (par value of \$1,746.0 million less discount of \$42.8 million). Following the Contribution, Alltel distributed 100 percent of the common shares of the Company to its shareholders as a tax-free dividend. Alltel also exchanged the Company Securities for certain Alltel debt held by certain investment banking firms. The investment banking firms subsequently sold the Company Securities in the private placement market. On November 28, 2006, the Company replaced the Company Securities with registered senior notes in the same amount with the same maturity.

Immediately following the Merger, the Company issued 8.125 percent senior notes due in 2013 in the aggregate principal amount of \$800.0 million which was used in part to repay the Valor credit facility in the amount of \$781.0 million. As part of the foregoing, Windstream assumed \$400.0 million principal in outstanding notes issued by subsidiaries of Valor. As a result, Windstream assumed or incurred approximately \$5.5 billion of long-term debt in connection with the Contribution and the Merger.

As discussed above, on December 12, 2006, Windstream announced that it would split off its directory publishing business in what Windstream expects to be a tax-free transaction with entities affiliated with WCAS, a private equity investment firm and Windstream shareholder. The Company will receive \$250.0 million in consideration in the form of a special dividend in an amount equal to its tax basis in the publishing business (currently estimated to be \$30.0 million), and debt securities with an aggregate principal amount of \$250.0 million less the amount of the special dividend. Windstream expects to exchange those debt securities for Windstream debt securities with an equivalent fair market value and then retire that Windstream debt. The transaction is expected to result in the retirement of at least \$220.0 million of outstanding Windstream debt. The transaction will also result in the repurchase of at least 19,574,422 shares of Windstream common stock, representing a value, at the time of signing, of approximately \$275.0 million based on a trailing average of Windstream's stock price of \$14.02 at that time. Given the value of the stock at the time of signing, the total value of the transaction was approximately \$525.0 million. Based on the trailing average of Windstream common stock at February 23, 2007 of \$15.05, the Exchanged WIN shares have a value of approximately \$295.0 million, increasing the expected total value of the transaction to approximately \$545.0 million.

Windstream's senior secured and senior unsecured credit ratings with Moody's Investors Service ("Moody's"), Standard & Poor's Corporation ("S&P") and Fitch Ratings ("Fitch") were as follows at December 31, 2006:

Description	Moody's	S&P	Fitch
Senior secured credit rating	Ba1	BBB-	BBB-
Senior unsecured credit rating	Ba3	BB-	BB+
Outlook	Stable	Negative	Stable

Factors that could affect Windstream's short and long-term credit ratings would include, but are not limited to, a material decline in the Company's operating results, increased debt levels relative to operating cash flows resulting from future acquisitions or increased capital expenditure requirements or changes to our dividend policy. If Windstream's credit ratings were to be downgraded from current levels, the Company would incur higher interest costs on its borrowings, and the Company's access to the public capital markets could be adversely affected. A downgrade in Windstream's current short or long-term credit ratings would not accelerate scheduled principal payments of Windstream's existing long-term debt.

The terms of our senior secured credit facilities and indentures include customary covenants that, among other things, require the Company to maintain certain financial ratios and restrict our ability to incur additional indebtedness. In particular, under the senior secured credit facilities, the Company must maintain the following financial ratios:

- (a) total leverage ratio must be no greater than 4.5 to 1.0 on the last day of any fiscal quarter;
- (b) interest coverage ratio must be greater than 2.75 to 1.0 on the last day of any fiscal quarter.

The leverage ratio is the ratio of indebtedness to adjusted EBITDA, and the interest coverage ratio is the ratio of adjusted EBITDA to cash interest expense. Adjusted EBITDA means (1) net income, adjusted to exclude the cumulative effect of accounting changes and certain other exceptions; plus (2) the following items, to the extent deducted from consolidated adjusted net income: (a) provision for taxes based on income or profits; (b) interest expense, to the extent deducted in computing net income; (c) depreciation, amortization, goodwill impairment charges and other non-cash expenses, subject to certain exceptions; plus (d) the amount of any minority interest expense deducted in computing net income; plus (e) any non-cash compensation charge arising from any grant of stock, stock options or other equity-based awards, to the extent deducted in computing net income; plus (f) certain non-cash income (or loss) related to hedging activities, to the extent deducted in computing net income; minus (g) non-cash items increasing such net income, subject to certain exceptions. The indentures governing the Company's senior notes contain similar covenants that in general are the same as or are no more restrictive than those contained in the senior secured credit facilities.

In addition, certain of the Company's debt agreements contain various covenants and restrictions specific to the subsidiary that is the legal counterparty to the agreement. Under the Company's long-term debt agreements, acceleration of principal payments would occur upon payment default, violation of debt covenants not cured within 30 days or breach of certain other conditions set forth in the borrowing agreements. At December 31, 2006, the Company was in compliance with all such covenants and restrictions.

Because of restrictions contained in the Merger Agreement with Alltel, Windstream may be limited in the amount of stock that it can issue to make acquisitions or raise additional capital in the two year period ending July 17, 2008 ("the restricted payment period").

These restrictions are intended to prevent Windstream from taking any actions that could cause the spin-off from Alltel to be taxable to Alltel under Section 355(e) of the Internal Revenue Code or otherwise jeopardize the tax-free status of the spin-off from Alltel or the Merger. In particular, during the restricted payment period, Windstream is prohibited from entering into any agreement, understanding or arrangement or engaging in any substantial negotiations with respect to any transaction involving the acquisition of Windstream stock or the issuance of shares of Windstream's stock, or options to acquire or other rights in respect of such stock, in excess of a permitted basket of 71,130,989 shares (as adjusted for stock splits, stock dividends, recapitalizations, reclassifications and similar transactions), unless, generally, the shares are issued to qualifying Windstream employees or retirement plans, each in accordance with "safe harbors" under regulations issued by the IRS. Nevertheless, Windstream can take any of the actions described above in the event that the IRS grants a favorable ruling to Alltel or Windstream as to the effect of such action on the tax-free status of the spin-off or Merger.

SELECTED FINANCIAL DATA

The following table presents certain selected consolidated financial data as of and for the years ended December 31:

(Millions, except per share amounts and customer data)	2006	2005	2004	2003	2002
Revenues and sales	\$ 3,033.3	\$ 2,923.5	\$ 2,933.5	\$ 3,003.3	\$ 2,835.7
Operating expenses	1,635.5	1,779.8	1,745.6	1,827.8	1,740.1
Depreciation and amortization expense	449.6	474.2	508.5	519.4	469.8
Restructuring and other charges	49.4	35.7	11.8	12.2	37.9
Total costs and expenses	2,134.5	2,289.7	2,265.9	2,359.4	2,247.8
Operating income	898.8	633.8	667.6	643.9	587.9
Other income, net	8.7	11.6	13.7	5.8	2.0
Loss on extinguishment of debt	(7.9)	—	—	—	—
Intercompany interest income (expense), net	31.9	23.3	(15.2)	(21.6)	(26.8)
Interest expense	(209.6)	(19.1)	(20.4)	(27.7)	(39.6)
Gain on disposal of assets, write-down of investments and other, net	—	—	—	23.9	—
Income before income taxes, extraordinary item and cumulative effect of accounting change	721.9	649.6	645.7	624.3	523.5
Income taxes	276.3	267.9	259.4	247.1	202.5
Income before extraordinary item and cumulative effect of accounting change	445.6	381.7	386.3	377.2	321.0
Extraordinary item, net of income taxes	99.7	—	—	—	—
Cumulative effect of accounting change, net of tax	—	(7.4)	—	15.6	—
Net income	\$ 545.3	\$ 374.3	\$ 386.3	\$ 392.8	\$ 321.0
Basic earnings per share:					
Income before extraordinary item and cumulative effect of accounting change	\$ 1.02	\$.95	\$.96	\$.93	\$.80
Extraordinary item	.23	—	—	—	—
Cumulative effect of accounting change	—	(.02)	—	.04	—
Net income	\$ 1.25	\$.93	\$.96	\$.97	\$.80
Diluted earnings per share:					
Income before extraordinary item and cumulative effect of accounting change	\$ 1.02	\$.95	\$.96	\$.93	\$.80
Extraordinary item	.23	—	—	—	—
Cumulative effect of accounting change	—	(.02)	—	.04	—
Net income	\$ 1.25	\$.93	\$.96	\$.97	\$.80
Dividends per common share	\$.45	\$ —	\$ —	\$ —	\$ —
Weighted average common shares:					
Basic	435.2	402.9	402.9	402.9	402.9
Diluted	435.4	402.9	402.9	402.9	402.9
Pro forma amounts assuming accounting changes applied retroactively:					
Net income	\$ 545.3	\$ 381.7	\$ 385.9	\$ 376.8	\$ 321.8
Basic earnings per share	\$ 1.25	\$.95	\$.96	\$.94	\$.80
Diluted earnings per share	\$ 1.25	\$.95	\$.96	\$.94	\$.80
Balance sheet data					
Total assets	\$ 8,030.7	\$ 4,935.8	\$ 5,079.2	\$ 5,276.9	\$ 5,519.8
Total equity	\$ 469.8	\$ 3,489.2	\$ 3,706.8	\$ 3,925.6	\$ 4,039.0
Total long-term debt (including current maturities)	\$ 5,488.4	\$ 260.8	\$ 282.9	\$ 304.8	\$ 587.3
Cash flows provided by (used in)					
Operating activities	\$ 1,125.2	\$ 954.6	\$ 968.3	\$ 1,135.0	\$ 822.4
Investing activities	\$ (299.0)	\$ (353.6)	\$ (335.6)	\$ (356.9)	\$ (2,164.3)
Financing activities	\$ (451.3)	\$ (602.4)	\$ (627.1)	\$ (784.2)	\$ 1,340.1
Statistical data					
Wireline access lines	3,242,931	2,885,673	3,009,388	3,095,635	3,167,275
Long distance customers	1,990,950	1,750,762	1,770,852	1,680,181	1,542,210

Broadband customers	656,132	397,696	243,325	153,028	70,182
Capital expenditures	\$ 373.9	\$ 356.9	\$ 337.8	\$ 396.8	\$ 414.0

OCA Exh. King 65 P

Notes to Selected Financial Information:

- A. During 2006, Windstream incurred \$27.6 million of incremental costs, principally consisting of rebranding costs, audit and legal fees, system conversion costs and employee related costs, related to the spin off from Alltel and merger with Valor. Windstream also incurred \$10.6 million in restructuring charges, which consisted of severance and employee benefit costs related to a planned workforce reduction. In addition, the Company incurred \$11.2 million in investment banker, audit and legal fees associated with the announced split-off of its directory publishing business. These restructuring charges decreased net income by \$36.0 million, giving effect to items not deductible for tax purposes. Effective January 1, 2006, Windstream prospectively reduced depreciation rates for its operations in Pennsylvania. In the second quarter of 2006 the Company prospectively reduced depreciation rates for its operations in Alabama and North Carolina, and in the fourth quarter 2006 it prospectively reduced depreciation rates for its operations in Arkansas and in one of its operating subsidiaries in Texas. The depreciable lives were lengthened to reflect the estimated remaining useful lives of the wireline plant based on Windstream's expected future network utilization and capital expenditure levels required to provide service to its customers. The effects of this change during the year ended December 31, 2006 resulted in a decrease in depreciation expense of \$30.1 million and an increase in net income of \$18.6 million.
- B. During 2005, Windstream incurred \$4.5 million of severance and employee benefit costs related to a workforce reduction in its wireline operations. Windstream also incurred \$31.2 million of incremental costs, principally consisting of investment banker, audit and legal fees, related to the then pending spin off from Alltel. These transactions decreased net income \$34.1 million. Effective July 1, 2005, Windstream prospectively reduced depreciation rates for its regulated operations in Florida, Georgia, North Carolina and South Carolina to reflect the results of studies of depreciable lives completed by the Company in the second quarter of 2005. The depreciable lives were lengthened to reflect the estimated remaining useful lives of wireline plant based on expected future network utilization and capital expenditure levels required to provide service to its customers. The effects of this change during the year ended December 31, 2005 resulted in a decrease in depreciation expense of \$21.8 million and increase in net income of \$12.8 million. Effective December 31, 2005, Windstream adopted Financial Accounting Standards Board Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations". The cumulative effect of this accounting change resulted in a one-time non-cash charge of \$7.4 million, net of income tax benefit of \$4.6 million.
- C. During 2004, Windstream reorganized its operations and support teams and also announced its plans to exit its competitive service operations in the Jacksonville, Florida market due to the continued unprofitability of these operations. In connection with these activities, Windstream recorded a restructuring charge of \$13.6 million consisting of \$11.6 million in severance and employee benefit costs related to a planned workforce reduction, \$1.3 million of employee relocation expenses and \$0.7 million of other exit costs. During 2004, the Company also recorded a \$1.8 million reduction in the liabilities associated with various restructuring activities initiated prior to 2003, consisting of lease and contract termination costs. The reduction primarily reflected differences between estimated and actual costs paid in completing the previous planned lease and contract terminations. These transactions decreased net income by \$7.3 million. Effective April 1, 2004, Windstream prospectively reduced depreciation rates for its regulated operations in Nebraska, reflecting the results of a triennial study of depreciable lives completed by Windstream in the second quarter of 2004, as required by the Nebraska Public Service Commission. The effects of this change during the year ended December 31, 2004 resulted in a decrease in depreciation expense of \$19.1 million and increase in net income of \$11.4 million.
- D. During 2003, Windstream recorded a restructuring charge of \$7.0 million consisting of severance and employee benefit costs related to a planned workforce reduction, primarily resulting from the closing of certain call center locations. Windstream also recorded a \$0.4 million reduction in the liabilities associated with various restructuring activities initiated prior to 2003, consisting of lease termination costs. The reduction primarily reflected differences between estimated and actual costs paid in completing previously planned lease terminations. During 2003, Windstream also wrote off certain capitalized software development costs that had no alternative future use or functionality. These transactions decreased net income \$7.4 million. In 2003, Windstream sold to Convergys Information Management Group, Inc. certain assets and related liabilities, including selected customer contracts and capitalized software development costs, associated with Windstream's telecommunications information services operations. In connection with this sale, Windstream recorded a pretax gain of \$31.0 million. In addition, during 2003, Windstream retired, prior to stated maturity dates, \$249.1 million of long-term debt, representing all of the long-term debt outstanding under the Rural Utilities Services, Rural Telephone Bank and Federal Financing Bank programs. In connection with the early retirement of the debt, Windstream incurred pretax termination fees of \$7.1 million. These transactions increased net income \$10.7 million. Effective January 1, 2003, Windstream adopted Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations". The cumulative effect of this accounting change resulted in a one-time non-cash credit of \$15.6 million, net of income tax expense of \$10.3 million.

Notes to Selected Financial Information, Continued:

E. In 2002, Windstream announced its plans to exit its competitive service operations in seven states representing less than 20 percent of its competitive access lines. During 2002, Windstream also consolidated its call center and product distribution operations. In connection with these activities, Windstream recorded restructuring charges totaling \$10.9 million consisting of \$8.2 million in severance and employee benefit costs related to planned workforce reductions and \$2.7 million of costs associated with terminating certain competitive service transport agreements and lease termination fees incurred with the closing of certain call center and product distribution locations. In exiting the competitive service operations, Windstream also incurred \$2.2 million of costs to disconnect and remove switching and other transmission equipment from central office facilities and expenses to notify and migrate customers to other service providers. Windstream also wrote off certain capitalized software development costs totaling \$4.1 million that had no alternative future use or functionality. These transactions decreased net income \$23.2 million.

On July 17, 2006, Windstream Corporation was formed through the spin-off of Alltel Corporation's ("Alltel") wireline telecommunications business to its stockholders, and the subsequent merger of that wireline business with Valor Communications Group, Inc. ("Valor"). The Company has presented in these schedules unaudited pro forma results from current businesses, which include results from Valor's businesses for periods prior to the merger, and excludes various non-recurring items related to the transaction, to the discontinuation of Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation" and to the split off of its directory publishing business in what Windstream expects to be a tax-free transaction with entities affiliated with Welsh, Carson, Anderson and Stowe ("WCAS"), a private equity investment firm. Windstream's purpose for including the results of Valor's businesses, and excluding non-recurring items and the directory publishing business, is to improve the comparability of results of operations in the three and six months ended June 30, 2007 to the results of operations for the same periods of 2006. Windstream's purpose for these adjustments is to focus on the true earnings capacity associated with providing telecommunication services. Management believes the items either included or excluded from pro forma results from current businesses are related to strategic activities or other events, specific to the time and opportunity available, and, accordingly, should be excluded when evaluating the Company's operations. The Company has updated its historical pro forma results by adding back severance expenses that were previously excluded in prior quarters. These types of expenses should not necessarily be viewed as non-recurring. For these reasons, management believes that presenting current business measures assists investors by providing more meaningful comparisons of results from current and prior periods, and by providing information that is a better reflection of the core earnings capacity of the businesses. The Company uses pro forma results from current businesses, including pro forma revenues and sales and pro forma OIBDA from current businesses, as a key measure of the operational performance of its business segments. Windstream management, including the chief operating decision-maker, uses these measures consistently for all purposes, including internal reporting purposes, the evaluation of business objectives, opportunities and performance, and the determination of management compensation.

On December 12, 2006, Windstream announced that it would split off its directory publishing business. In exchange for Windstream's publishing business, WCAS will pay Windstream a special dividend, issue debt, execute a debt-for-debt exchange and relinquish approximately 19.6 million shares in Windstream common stock. Operating results of the publishing business have been excluded from pro forma revenues and sales and pro forma OIBDA from current businesses. On May 25, 2007, Windstream entered into a definitive agreement to acquire CT Communications, Inc. ("CT Communications") for \$31.50 per outstanding share of CT Communications' outstanding common stock, or approximately \$585.0 million. Pro forma results from current businesses presented herein do not include adjustments for the operating results of CT Communications.

Windstream claims the protection of the safe-harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to uncertainties that could cause actual future events and results to differ materially from those expressed in the forward-looking statements. These forward-looking statements are based on estimates, projections, beliefs and assumptions that Windstream believes are reasonable but are not guarantees of future events and results. Actual future events and results of Windstream may differ materially from those expressed in these forward-looking statements as a result of a number of important factors. Factors that could cause actual results to differ materially from those contemplated above include, among others: adverse changes in economic conditions in the markets served by Windstream; the extent, timing and overall effects of competition in the communications business; continued access line loss; the impact of new, emerging or competing technologies; the risks associated with the integration of acquired businesses or the ability to realize anticipated synergies, cost savings and growth opportunities; the availability and cost of financing in the corporate debt markets; the potential for adverse changes in the ratings given to Windstream's debt securities by nationally accredited ratings organizations; the effects of federal and state legislation, rules and regulations governing the communications industry; the adoption of inter-carrier compensation and/or universal service reform proposal by the Federal Communications Commission or Congress that results in a significant loss of revenue to Windstream; an adverse development regarding the tax treatment of the spin-off from Alltel on July 17, 2006, and the restrictions on certain financing and other activities imposed by the tax sharing agreement with Alltel; the failure to successfully complete the contemplated split off of our directory publishing business, Windstream Yellow Pages, in what Windstream expects to be a tax-free transaction to affiliates of Welsh, Carson, Anderson & Stowe; material changes in the communications industry generally that could adversely affect vendor relationships with equipment and network suppliers and customer relationships with wholesale customers; unexpected results of litigation; the effects of work stoppages; the impact of equipment failure, natural disasters or terrorist acts; and those additional factors under the caption "Risk Factors" in Windstream's Form 10-K for the year ended Dec. 31, 2006. In addition to these factors, actual future performance, outcomes and results may differ materially because of more general factors including, among others, general industry and market conditions and growth rates, economic conditions, and governmental and public policy changes. Windstream undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. The foregoing review of factors that could cause Windstream's actual results to differ materially from those contemplated in the forward-looking statements should be considered in connection with information regarding risks and uncertainties that may affect Windstream's future results included in Windstream's filings with the Securities and Exchange Commission.

WINDSTREAM CORPORATION
 UNAUDITED PRO FORMA CONSOLIDATED RESULTS FROM CURRENT BUSINESSES (NON-GAAP) (A)
 QUARTERLY SUPPLEMENTAL BUSINESS SEGMENT INFORMATION
 for the quarterly periods in the years 2007, 2006 and 2005
 (In millions)

	2007			2006					2005				
	Total	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.
Wireline													
Revenues and sales:													
Service revenues	\$ 1,474.7	\$ 746.2	\$ 728.5	\$ 2,916.6	\$ 742.7	\$ 725.6	\$ 723.2	\$ 725.1	\$ 2,942.6	\$ 733.5	\$ 738.8	\$ 732.0	\$ 738.3
Product sales	28.5	15.6	12.9	47.2	13.7	11.7	11.4	10.4	46.4	10.8	13.4	11.7	10.5
Total revenues and sales	1,503.2	761.8	741.4	2,963.8	756.4	737.3	734.6	735.5	2,989.0	744.3	752.2	743.7	748.8
Costs and expenses:													
Cost of services	504.1	259.4	244.7	962.0	240.8	250.4	233.9	236.9	967.9	227.2	244.3	250.5	245.9
Cost of products sold	23.9	11.6	12.3	39.6	12.7	8.6	9.9	8.4	35.0	7.7	10.6	9.7	7.0
Selling, general, administrative and other	177.9	88.4	89.5	368.9	94.8	85.9	96.9	91.3	393.1	98.2	95.7	94.6	104.6
Total cash expenses	705.9	359.4	346.5	1,370.5	348.3	344.9	340.7	336.6	1,396.0	333.1	350.6	354.8	357.5
Wireline OIBDA (C)	797.3	402.4	394.9	1,593.3	408.1	392.4	393.9	398.9	1,593.0	411.2	401.6	388.9	391.3
Depreciation and amortization	251.7	127.1	124.6	514.0	122.9	129.7	129.3	132.1	592.9	137.6	148.4	152.6	154.3
Segment income	\$ 545.6	\$ 275.3	\$ 270.3	\$ 1,079.3	\$ 285.2	\$ 262.7	\$ 264.6	\$ 266.8	\$ 1,000.1	\$ 273.6	\$ 253.2	\$ 236.3	\$ 237.0
Product distribution													
Revenues and sales:													
Product sales	\$ 168.7	85.5	\$ 83.2	\$ 334.9	\$ 101.0	\$ 81.8	\$ 83.0	\$ 69.1	\$ 307.9	\$ 81.8	\$ 76.1	\$ 81.2	\$ 68.8
Total revenues and sales	168.7	85.5	83.2	334.9	101.0	81.8	83.0	69.1	307.9	81.8	76.1	81.2	68.8
Costs and expenses:													
Cost of products sold	157.8	79.9	77.9	312.4	95.3	75.3	77.5	64.3	289.3	76.4	71.4	76.5	65.0
Selling, general, administrative and other	11.1	5.1	6.0	13.8	5.0	5.7	1.1	2.0	9.6	2.0	2.5	3.4	1.7
Total cash expenses	168.9	85.0	83.9	326.2	100.3	81.0	78.6	66.3	298.9	78.4	73.9	79.9	66.7
Product distribution OIBDA (C)	(0.2)	0.5	(0.7)	8.7	0.7	0.8	4.4	2.8	9.0	3.4	2.2	1.3	2.1
Depreciation and amortization	0.3	0.2	0.1	1.9	0.6	0.2	0.5	0.6	2.3	0.5	0.5	0.6	0.7
Segment income	\$ (0.5)	\$ 0.3	\$ (0.8)	\$ 6.8	\$ 0.1	\$ 0.6	\$ 3.9	\$ 2.2	\$ 6.7	\$ 2.9	\$ 1.7	\$ 0.7	\$ 1.4
Intercompany eliminations:													
Revenues and sales:													
Service revenues	\$ (23.3)	\$ (11.9)	\$ (11.4)	\$ (58.9)	\$ (10.1)	\$ (9.4)	\$ (18.6)	\$ (20.8)	\$ (75.6)	\$ (19.6)	\$ (20.3)	\$ (14.6)	\$ (21.1)
Product sales	(104.9)	(52.5)	(52.4)	(199.4)	(65.8)	(46.9)	(49.5)	(37.2)	(187.1)	(51.9)	(44.0)	(50.1)	(41.1)
Total revenues and sales	(128.2)	(64.4)	(63.8)	(258.3)	(75.9)	(56.3)	(68.1)	(58.0)	(262.7)	(71.5)	(64.3)	(64.7)	(62.2)
Costs and expenses:													
Cost of services	(22.7)	(11.5)	(11.2)	(68.2)	(7.0)	(12.7)	(27.0)	(21.5)	(103.6)	(30.4)	(24.2)	(28.2)	(20.8)
Cost of products sold	(105.5)	(52.9)	(52.6)	(190.1)	(68.9)	(43.6)	(41.1)	(36.5)	(159.1)	(41.1)	(40.1)	(36.5)	(41.4)
Total cash expenses	(128.2)	(64.4)	(63.8)	(258.3)	(75.9)	(56.3)	(68.1)	(58.0)	(262.7)	(71.5)	(64.3)	(64.7)	(62.2)
OIBDA (C)	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation and amortization	-	-	-	-	-	-	-	-	-	-	-	-	-
Operating income	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Consolidated:													
Revenues and sales:													
Service revenues	1,451.4	734.3	717.1	2,857.7	732.6	716.2	704.6	704.3	2,867.0	713.9	718.5	717.4	717.2
Product sales	92.3	48.6	43.7	182.7	48.9	46.6	44.9	42.3	167.2	40.7	45.5	42.8	38.2
Total revenues and sales	\$ 1,543.7	\$ 782.9	\$ 760.8	\$ 3,040.4	\$ 781.5	\$ 762.8	\$ 749.5	\$ 746.6	\$ 3,034.2	\$ 754.6	\$ 764.0	\$ 760.2	\$ 755.4
Costs and expenses:													
Cost of services	481.4	247.9	233.5	893.8	233.8	237.7	206.9	215.4	864.3	196.8	220.1	222.3	225.1
Cost of products sold	76.2	38.6	37.6	161.9	39.1	40.3	46.3	36.2	165.2	43.0	41.9	49.7	30.6
Selling, general, administrative and other	189.0	93.5	93.5	382.7	99.8	91.6	98.0	93.3	402.7	100.2	98.2	98.0	106.3
Restructuring and other charges	3.2	-	3.2	10.6	10.6	-	-	-	4.5	(0.2)	4.7	-	-
Total cash expenses	749.8	380.0	369.8	1,449.0	383.3	369.6	351.2	344.9	1,436.7	339.8	364.9	370.0	362.0
OIBDA (C)	793.9	402.9	391.0	1,591.4	398.2	392.2	398.3	401.7	1,597.5	414.8	399.1	390.2	393.4
Depreciation and amortization	252.0	127.3	124.7	515.9	123.5	129.9	129.8	132.7	595.2	138.1	148.9	153.2	155.0
Operating income	\$ 541.9	\$ 275.6	\$ 266.3	\$ 1,075.5	\$ 274.7	\$ 263.3	\$ 268.5	\$ 269.0	\$ 1,002.3	\$ 276.7	\$ 250.2	\$ 237.0	\$ 238.4

WINDSTREAM CORPORATION
 UNAUDITED PRO FORMA CONSOLIDATED RESULTS FROM CURRENT BUSINESSES (NON-GAAP) (A)
 QUARTERLY SUPPLEMENTAL BUSINESS SEGMENT INFORMATION
 for the quarterly periods in the years 2007, 2006 and 2005
 (In millions)

	2007			2006					2005				
	Total	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.
Operating Income Margin: (B)													
Wireline	36.3%	36.1%	36.5%	36.4%	37.7%	35.6%	36.0%	36.3%	33.5%	36.8%	33.7%	31.8%	31.7%
Product distribution	-0.3%	0.4%	-1.0%	2.0%	0.0%	0.9%	4.6%	3.1%	2.2%	3.5%	2.2%	0.8%	2.1%
Consolidated	35.1%	35.2%	35.0%	35.4%	35.2%	34.5%	35.8%	36.0%	33.0%	36.7%	32.7%	31.2%	31.6%
OIBDA Margin (D)													
Wireline	53.0%	52.8%	53.3%	53.8%	54.0%	53.2%	53.6%	54.2%	53.3%	55.3%	53.4%	52.3%	52.3%
Product distribution	-0.1%	0.6%	-0.8%	2.6%	0.7%	1.1%	5.3%	3.9%	2.9%	4.1%	2.9%	1.6%	3.1%
Consolidated	51.4%	51.5%	51.4%	52.3%	51.0%	51.3%	53.1%	53.8%	52.6%	55.0%	52.2%	51.3%	52.1%

SUPPLEMENTAL REVENUE INFORMATION:

Wireline:

Revenues and sales:

Voice	\$ 631.0	\$ 314.4	\$ 316.6	\$ 1,305.7	\$ 317.6	\$ 322.9	\$ 329.4	\$ 335.8	\$ 1,371.3	\$ 334.3	\$ 343.5	\$ 346.2	\$ 347.3
Long distance	125.8	63.8	62.0	230.4	65.1	57.0	54.7	53.6	213.4	53.0	56.9	51.3	52.2
Data and special access	331.7	168.9	162.8	611.1	159.2	154.1	150.7	147.1	553.7	144.7	140.0	136.0	133.0
Switched access and USF	299.0	156.3	142.7	612.1	158.0	149.7	152.0	152.4	655.9	164.4	161.1	162.4	168.0
Miscellaneous	87.2	42.8	44.4	157.3	42.8	41.9	36.4	36.2	148.1	37.1	37.3	36.0	37.8
Product sales	28.5	15.6	12.9	47.2	13.7	11.7	11.4	10.4	46.5	10.8	13.4	11.8	10.5
Total revenues and sales	\$ 1,503.2	\$ 761.8	\$ 741.4	\$ 2,963.8	\$ 756.4	\$ 737.3	\$ 734.6	\$ 735.5	\$ 2,989.0	\$ 744.3	\$ 752.2	\$ 743.7	\$ 748.8

- (A) Pro forma results from current businesses adjust results of operations under Generally Accepted Accounting Principles ("GAAP") for the effects of the spin-off of the Alltel Corporation ("Alltel") wireline division and merger of that business with Valor Communications Group, Inc. ("Valor"), the discontinuance of SFAS No. 71 and the split off of its directory publishing business, as of January 1, 2005.
- (B) Operating income margin is calculated by dividing segment income by the corresponding amount of segment revenues and sales before intercompany eliminations.
- (C) OIBDA is segment income before depreciation and amortization.
- (D) OIBDA margin is calculated by dividing segment income before depreciation and amortization by the corresponding amount of segment revenues and sales before intercompany eliminations.

WINDSTREAM CORPORATION
 UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION (A)
 QUARTERLY SUPPLEMENTAL BUSINESS SEGMENT INFORMATION FROM CURRENT BUSINESSES (NON-GAAP)
 for the quarterly periods in the years 2007, 2006 and 2005
 (Dollars in millions, except per customer amounts)

	2007			2006				2005					
	Total	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.
Wireline:													
Access lines	3,179.2	3,179.2	3,214.3	3,242.9	3,242.9	3,287.6	3,328.2	3,366.1	3,391.0	3,391.0	3,431.4	3,470.2	3,507.2
YOY change in access lines	-4.48%	-4.48%	-4.51%	-4.37%	-4.37%	-4.19%	-4.09%	-4.02%	-4.13%	-4.13%	-4.05%	-3.81%	-3.53%
Net access line losses	(63.7)	(35.1)	(28.6)	(148.1)	(44.6)	(40.7)	(37.9)	(24.9)	(145.7)	(40.5)	(38.7)	(37.0)	(29.5)
Average access lines	3,211.7	3,197.7	3,226.3	3,304.7	3,264.6	3,308.0	3,348.1	3,376.9	3,467.1	3,409.8	3,451.6	3,488.6	3,520.3
Broadband customers	752.6	752.6	715.4	656.1	656.1	603.1	547.8	502.4	450.4	450.4	407.2	359.3	314.2
Net broadband additions	96.5	37.3	59.2	205.8	53.0	55.3	45.5	52.0	184.2	43.2	47.8	45.2	48.0
YOY change in broadband customers	37.39%	37.39%	42.40%	45.69%	45.69%	48.11%	52.42%	59.84%	69.21%	69.21%	74.50%	74.02%	70.36%
Average revenue per customer per month (B)	\$78.01	\$79.41	\$76.60	\$74.74	\$77.23	\$74.29	\$73.14	\$72.60	\$71.84	\$72.76	\$72.64	\$71.06	\$70.90
Digital satellite television customers	150.2	150.2	122.3	87.7	87.7	61.5	42.8	29.1	9.3	9.3	0.3	-	-
Long distance customers	1,974.9	1,974.9	1,981.5	1,991.0	1,991.0	2,006.9	2,001.7	1,987.6	1,982.8	1,982.8	1,986.6	2,007.2	2,015.9
Consolidated:													
Capital expenditures	\$177.9	\$97.9	\$80.0	\$401.3	\$130.0	\$90.5	\$106.9	\$73.9	\$408.5	\$131.1	\$92.3	\$96.2	\$88.9
Reconciliation of Operating Income under GAAP to OIBDA from Current Businesses:													
Operating income under GAAP	\$ 562.4	\$ 292.8	\$ 269.6	\$ 898.9	\$ 285.7	\$ 254.0	\$ 185.3	\$ 173.9	\$ 633.8	\$ 168.2	\$ 162.2	\$ 151.2	\$ 152.2
Pro forma adjustments													
Wireline operating income adjustment for split off of directory publishing	(21.0)	(14.1)	(6.9)	(53.9)	(20.6)	(12.2)	(14.1)	(7.0)	(55.9)	(21.1)	(11.4)	(16.5)	(6.9)
Other operating income adjustment for split off of directory publishing	(2.7)	(4.7)	2.0	(10.7)	(6.4)	(0.5)	(4.9)	1.1	(9.1)	(5.0)	(0.9)	(3.8)	0.6
Valor Communications Group, Inc. operating income	-	-	-	80.9	-	(6.9)	43.5	44.3	167.0	43.2	41.3	44.9	37.6
Customer list amortization	-	-	-	(24.1)	-	(2.1)	(11.0)	(11.0)	(44.0)	(11.0)	(11.0)	(11.0)	(11.0)
Royalty expense	-	-	-	129.5	-	-	62.4	67.1	268.7	66.5	67.4	67.4	67.4
Restructuring and other charges	3.2	1.6	1.6	54.5	16.0	31.0	5.0	2.5	33.2	32.3	0.9	-	-
Discontinuance of SFAS No. 71	-	-	-	0.4	-	-	2.3	(1.9)	8.6	3.6	1.7	4.8	(1.5)
Adjusted operating income	541.9	275.6	266.3	1,075.5	274.7	263.3	268.5	269.0	1,002.3	276.7	250.2	237.0	238.4
Depreciation and amortization expense	252.0	126.9	125.1	517.5	123.9	130.3	130.2	133.1	596.8	138.5	149.3	153.6	155.4
Depreciation and amortization adjustment for split off of directory publishing	-	0.4	(0.4)	(1.6)	(0.4)	(0.4)	(0.4)	(0.4)	(1.6)	(0.4)	(0.4)	(0.4)	(0.4)
Pro forma OIBDA from current businesses (C)	\$ 793.9	\$ 402.9	\$ 391.0	\$ 1,591.4	\$ 398.2	\$ 393.2	\$ 398.3	\$ 401.7	\$ 1,597.5	\$ 414.8	\$ 399.1	\$ 390.2	\$ 393.4

(A) Pro forma results of operations from current businesses adjusts results of operations under Generally Accepted Accounting Principles ("GAAP") for the effects of the spin-off of the Alltel Corporation ("Alltel") wireline division and merger of that business with Valor Communications Group, Inc. ("Valor"), the discontinuance of SFAS No. 71 and the split off of its directory publishing business, as of January 1, 2005.

(B) Average revenue per customer per month is calculated by dividing total wireline revenues by average customers for the period.

(C) OIBDA is operating income before depreciation and amortization.

On July 17, 2006, Windstream Corporation was formed through the spin-off of Alltel Corporation's ("Alltel") wireline telecommunications business to its stockholders, and the subsequent merger of that wireline business with Valor Communications Group, Inc. ("Valor"). The Company has presented in these schedules unaudited pro forma results from current businesses, which include results from Valor's businesses for periods prior to the merger, and excludes various non-recurring items related to the transaction, to the discontinuation of Statement of Financial Accounting Standards ("SFAS") No. 71, "Accounting for the Effects of Certain Types of Regulation" and to the split off of its directory publishing business in what Windstream expects to be a tax-free transaction with entities affiliated with Welsh, Carson, Anderson and Stowe ("WCAS"), a private equity investment firm. Windstream's purpose for including the results of Valor's businesses, and excluding non-recurring items and the directory publishing business, is to improve the comparability of results of operations in the three and six months ended June 30, 2007 to the results of operations for the same periods of 2006. Windstream's purpose for these adjustments is to focus on the true earnings capacity associated with providing telecommunication services. Management believes the items either included or excluded from pro forma results from current businesses are related to strategic activities or other events, specific to the time and opportunity available, and, accordingly, should be excluded when evaluating the Company's operations. The Company has updated its historical pro forma results by adding back severance expenses that were previously excluded in prior quarters. These types of expenses should not necessarily be viewed as non-recurring. For these reasons, management believes that presenting current business measures assists investors by providing more meaningful comparisons of results from current and prior periods, and by providing information that is a better reflection of the core earnings capacity of the businesses. The Company uses pro forma results from current businesses, including pro forma revenues and sales and pro forma OIBDA from current businesses, as a key measure of the operational performance of its business segments. Windstream management, including the chief operating decision-maker, uses these measures consistently for all purposes, including internal reporting purposes, the evaluation of business objectives, opportunities and performance, and the determination of management compensation.

On December 12, 2006, Windstream announced that it would split off its directory publishing business. In exchange for Windstream's publishing business, WCAS will pay Windstream a special dividend, issue debt, execute a debt-for-debt exchange and relinquish approximately 19.6 million shares in Windstream common stock. Operating results of the publishing business have been excluded from pro forma revenues and sales and pro forma OIBDA from current businesses. On May 25, 2007, Windstream entered into a definitive agreement to acquire CT Communications, Inc. ("CT Communications") for \$31.50 per outstanding share of CT Communications' outstanding common stock, or approximately \$585.0 million. Pro forma results from current businesses presented herein do not include adjustments for the operating results of CT Communications.

Windstream claims the protection of the safe-harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to uncertainties that could cause actual future events and results to differ materially from those expressed in the forward-looking statements. These forward-looking statements are based on estimates, projections, beliefs and assumptions that Windstream believes are reasonable but are not guarantees of future events and results. Actual future events and results of Windstream may differ materially from those expressed in these forward-looking statements as a result of a number of important factors. Factors that could cause actual results to differ materially from those contemplated above include, among others: adverse changes in economic conditions in the markets served by Windstream; the extent, timing and overall effects of competition in the communications business; continued access line loss; the impact of new, emerging or competing technologies; the risks associated with the integration of acquired businesses or the ability to realize anticipated synergies, cost savings and growth opportunities; the availability and cost of financing in the corporate debt markets; the potential for adverse changes in the ratings given to Windstream's debt securities by nationally accredited ratings organizations; the effects of federal and state legislation, rules and regulations governing the communications industry; the adoption of inter-carrier compensation and/or universal service reform proposal by the Federal Communications Commission or Congress that results in a significant loss of revenue to Windstream; an adverse development regarding the tax treatment of the spin-off from Alltel on July 17, 2006, and the restrictions on certain financing and other activities imposed by the tax sharing agreement with Alltel; the failure to successfully complete the contemplated split off of our directory publishing business, Windstream Yellow Pages, in what Windstream expects to be a tax-free transaction to affiliates of Welsh, Carson, Anderson & Stowe; material changes in the communications industry generally that could adversely affect vendor relationships with equipment and network suppliers and customer relationships with wholesale customers; unexpected results of litigation; the effects of work stoppages; the impact of equipment failure, natural disasters or terrorist acts; and those additional factors under the caption "Risk Factors" in Windstream's Form 10-K for the year ended Dec. 31, 2006. In addition to these factors, actual future performance, outcomes and results may differ materially because of more general factors including, among others, general industry and market conditions and growth rates, economic conditions, and governmental and public policy changes. Windstream undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. The foregoing review of factors that could cause Windstream's actual results to differ materially from those contemplated in the forward-looking statements should be considered in connection with information regarding risks and uncertainties that may affect Windstream's future results included in Windstream's filings with the Securities and Exchange Commission.

WINDSTREAM CORPORATION
 UNAUDITED PRO FORMA CONSOLIDATED RESULTS FROM CURRENT BUSINESSES (NON-GAAP) (A)
 QUARTERLY SUPPLEMENTAL BUSINESS SEGMENT INFORMATION
 for the quarterly periods in the years 2007, 2006 and 2005
 (In millions)

	2007			2006					2005				
	Total	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.
Wireline													
Revenues and sales:													
Service revenues	\$ 1,474.7	\$ 746.2	\$ 728.5	\$ 2,916.6	\$ 742.7	\$ 725.6	\$ 723.2	\$ 725.1	\$ 2,942.6	\$ 733.5	\$ 738.8	\$ 732.0	\$ 738.3
Product sales	28.5	15.6	12.9	47.2	13.7	11.7	11.4	10.4	46.4	10.8	13.4	11.7	10.5
Total revenues and sales	1,503.2	761.8	741.4	2,963.8	756.4	737.3	734.6	735.5	2,989.0	744.3	752.2	743.7	748.8
Costs and expenses:													
Cost of services	504.1	259.4	244.7	962.0	240.8	250.4	233.9	236.9	967.9	227.2	244.3	250.5	245.9
Cost of products sold	23.9	11.6	12.3	39.6	12.7	8.6	9.9	8.4	35.0	7.7	10.6	9.7	7.0
Selling, general, administrative and other	177.9	88.4	89.5	368.9	94.8	85.9	96.9	91.3	393.1	98.2	95.7	94.6	104.6
Total cash expenses	705.9	359.4	346.5	1,370.5	348.3	344.9	340.7	336.6	1,396.0	333.1	350.6	354.8	357.5
Wireline OIBDA (C)	797.3	402.4	394.9	1,593.3	408.1	392.4	393.9	398.9	1,593.0	411.2	401.6	388.9	391.3
Depreciation and amortization	251.7	127.1	124.6	514.0	122.9	129.7	129.3	132.1	592.9	137.6	148.4	152.6	154.3
Segment income	\$ 545.6	\$ 275.3	\$ 270.3	\$ 1,079.3	\$ 285.2	\$ 262.7	\$ 264.6	\$ 266.8	\$ 1,000.1	\$ 273.6	\$ 253.2	\$ 236.3	\$ 237.0
Product distribution													
Revenues and sales:													
Product sales	\$ 168.7	\$ 85.5	\$ 83.2	\$ 334.9	\$ 101.0	\$ 81.8	\$ 83.0	\$ 69.1	\$ 307.9	\$ 81.8	\$ 76.1	\$ 81.2	\$ 68.8
Total revenues and sales	168.7	85.5	83.2	334.9	101.0	81.8	83.0	69.1	307.9	81.8	76.1	81.2	68.8
Costs and expenses:													
Cost of products sold	157.8	79.9	77.9	312.4	95.3	75.3	77.5	64.3	289.3	76.4	71.4	76.5	65.0
Selling, general, administrative and other	11.1	5.1	6.0	13.8	5.0	5.7	1.1	2.0	9.6	2.0	2.5	3.4	1.7
Total cash expenses	168.9	85.0	83.9	326.2	100.3	81.0	78.6	66.3	298.9	78.4	73.9	79.9	66.7
Product distribution OIBDA (C)	(0.2)	0.5	(0.7)	8.7	0.7	0.8	4.4	2.8	9.0	3.4	2.2	1.3	2.1
Depreciation and amortization	0.3	0.2	0.1	1.9	0.6	0.2	0.5	0.6	2.3	0.5	0.5	0.6	0.7
Segment income	\$ (0.5)	\$ 0.3	\$ (0.8)	\$ 6.8	\$ 0.1	\$ 0.6	\$ 3.9	\$ 2.2	\$ 6.7	\$ 2.9	\$ 1.7	\$ 0.7	\$ 1.4
Intercompany eliminations:													
Revenues and sales:													
Service revenues	\$ (23.3)	\$ (11.9)	\$ (11.4)	\$ (58.9)	\$ (10.1)	\$ (9.4)	\$ (18.6)	\$ (20.8)	\$ (75.6)	\$ (19.6)	\$ (20.3)	\$ (14.6)	\$ (21.1)
Product sales	(104.9)	(52.5)	(52.4)	(199.4)	(65.8)	(46.9)	(49.5)	(37.2)	(187.1)	(51.9)	(44.0)	(50.1)	(41.1)
Total revenues and sales	(128.2)	(64.4)	(63.8)	(258.3)	(75.9)	(56.3)	(68.1)	(58.0)	(262.7)	(71.5)	(64.3)	(64.7)	(62.2)
Costs and expenses:													
Cost of services	(22.7)	(11.5)	(11.2)	(68.2)	(7.0)	(12.7)	(27.0)	(21.5)	(103.6)	(30.4)	(24.2)	(28.2)	(20.8)
Cost of products sold	(105.5)	(52.9)	(52.6)	(190.1)	(68.9)	(43.6)	(41.1)	(36.5)	(159.1)	(41.1)	(40.1)	(36.5)	(41.4)
Total cash expenses	(128.2)	(64.4)	(63.8)	(258.3)	(75.9)	(56.3)	(68.1)	(58.0)	(262.7)	(71.5)	(64.3)	(64.7)	(62.2)
OIBDA (C)	-	-	-	-	-	-	-	-	-	-	-	-	-
Depreciation and amortization	-	-	-	-	-	-	-	-	-	-	-	-	-
Operating income	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Consolidated:													
Revenues and sales:													
Service revenues	1,451.4	734.3	717.1	2,857.7	732.6	716.2	704.6	704.3	2,867.0	713.9	718.5	717.4	717.2
Product sales	92.3	48.6	43.7	182.7	48.9	46.6	44.9	42.3	167.2	40.7	45.5	42.8	38.2
Total revenue and sales	\$ 1,543.7	\$ 782.9	\$ 760.8	\$ 3,040.4	\$ 781.5	\$ 762.8	\$ 749.5	\$ 746.6	\$ 3,034.2	\$ 754.6	\$ 764.0	\$ 760.2	\$ 755.4
Costs and expenses:													
Cost of services	481.4	247.9	233.5	893.8	233.8	237.7	206.9	215.4	864.3	196.8	220.1	222.3	225.1
Cost of products sold	76.2	38.6	37.6	161.9	39.1	40.3	46.3	36.2	165.2	43.0	41.9	49.7	30.6
Selling, general, administrative and other	189.0	93.5	95.5	382.7	99.8	91.6	98.0	93.3	402.7	100.2	98.2	98.0	106.3
Restructuring and other charges	3.2	-	3.2	10.6	10.6	-	-	-	4.5	(0.2)	4.7	-	-
Total cash expenses	749.8	380.0	369.8	1,449.0	383.3	369.6	351.2	344.9	1,436.7	339.8	364.9	370.0	362.0
OIBDA (C)	793.9	402.9	391.0	1,591.4	398.2	393.2	398.3	401.7	1,597.5	414.8	399.1	390.2	393.4
Depreciation and amortization	252.0	127.3	124.7	515.9	123.5	129.9	129.8	132.7	595.2	138.1	148.9	153.2	155.0
Operating income	\$ 541.9	\$ 275.6	\$ 266.3	\$ 1,075.5	\$ 274.7	\$ 263.3	\$ 268.5	\$ 269.0	\$ 1,002.3	\$ 276.7	\$ 250.2	\$ 237.0	\$ 238.4

WINDSTREAM CORPORATION
 UNAUDITED PRO FORMA CONSOLIDATED RESULTS FROM CURRENT BUSINESSES (NON-GAAP) (A)
 QUARTERLY SUPPLEMENTAL BUSINESS SEGMENT INFORMATION
 for the quarterly periods in the years 2007, 2006 and 2005
 (In millions)

	2007			2006					2005				
	Total	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.
Operating Income Margin: (B)													
Wireline	36.3%	36.1%	36.5%	36.4%	37.7%	35.6%	36.0%	36.3%	33.5%	36.8%	33.7%	31.8%	31.7%
Product distribution	-0.3%	0.4%	-1.0%	2.0%	0.0%	0.9%	4.6%	3.1%	2.2%	3.5%	2.2%	0.8%	2.1%
Consolidated	35.1%	35.2%	35.0%	35.4%	35.2%	34.5%	35.8%	36.0%	33.0%	36.7%	32.7%	31.2%	31.6%
OIBDA Margin (D)													
Wireline	53.0%	52.8%	53.3%	53.8%	54.0%	53.2%	53.6%	54.2%	53.3%	55.3%	53.4%	52.3%	52.3%
Product distribution	-0.1%	0.6%	-0.8%	2.6%	0.7%	1.1%	5.3%	3.9%	2.9%	4.1%	2.9%	1.6%	3.1%
Consolidated	51.4%	51.5%	51.4%	52.3%	51.0%	51.5%	53.1%	53.8%	52.6%	55.0%	52.2%	51.3%	52.1%

SUPPLEMENTAL REVENUE INFORMATION.

Wireline:

Revenues and sales:

Voice	\$ 631.0	\$ 314.4	\$ 316.6	\$ 1,305.7	\$ 317.6	\$ 322.9	\$ 329.4	\$ 335.8	\$ 1,371.3	\$ 334.3	\$ 343.5	\$ 346.2	\$ 347.3
Long distance	125.8	63.8	62.0	230.4	65.1	57.0	54.7	53.6	213.4	53.0	56.9	51.3	52.2
Data and special access	331.7	168.9	162.8	611.1	159.2	154.1	150.7	147.1	553.7	144.7	140.0	136.0	133.0
Switched access and USF	299.0	156.3	142.7	612.1	158.0	149.7	152.0	152.4	655.9	164.4	161.1	162.4	168.0
Miscellaneous	87.2	42.8	44.4	157.3	42.8	41.9	36.4	36.2	148.2	37.1	37.3	36.0	37.8
Product sales	28.5	15.6	12.9	47.2	13.7	11.7	11.4	10.4	46.5	10.8	13.4	11.8	10.5
Total revenues and sales	\$ 1,503.2	\$ 761.8	\$ 741.4	\$ 2,963.8	\$ 756.4	\$ 737.3	\$ 734.6	\$ 735.5	\$ 2,989.0	\$ 744.3	\$ 752.2	\$ 743.7	\$ 748.8

- (A) Pro forma results from current businesses adjust results of operations under Generally Accepted Accounting Principles ("GAAP") for the effects of the spin-off of the Alltel Corporation ("Alltel") wireline division and merger of that business with Valor Communications Group, Inc. (Valor), the discontinuance of SFAS No. 71 and the split off of its directory publishing business, as of January 1, 2005.
- (B) Operating income margin is calculated by dividing segment income by the corresponding amount of segment revenues and sales before intercompany eliminations.
- (C) OIBDA is segment income before depreciation and amortization.
- (D) OIBDA margin is calculated by dividing segment income before depreciation and amortization by the corresponding amount of segment revenues and sales before intercompany eliminations.

WINDSTREAM CORPORATION
UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL INFORMATION (A)
QUARTERLY SUPPLEMENTAL BUSINESS SEGMENT INFORMATION FROM CURRENT BUSINESSES (NON-GAAP)
for the quarterly periods in the years 2007, 2006 and 2005
(Dollars in millions, except per customer amounts)

	2007			2006					2005				
	Total	2nd Qtr.	1st Qtr.	Total	4th Qtr.	2nd Qtr.	2nd Qtr.	1st Qtr.	Total	4th Qtr.	3rd Qtr.	2nd Qtr.	1st Qtr.
Wireline:													
Access lines	3,179.2	3,179.2	3,214.3	3,242.9	3,242.9	3,287.6	3,328.2	3,366.1	3,391.0	3,391.0	3,431.4	3,470.2	3,507.2
<i>YOY change in access lines</i>	-4.48%	-4.48%	-4.51%	-4.37%	-4.37%	-4.19%	-4.09%	-4.02%	-4.13%	-4.13%	-4.05%	-3.81%	-3.53%
Net access line losses	(63.7)	(35.1)	(28.6)	(148.1)	(44.6)	(40.7)	(37.9)	(24.9)	(145.7)	(40.5)	(38.7)	(37.0)	(29.5)
Average access lines	3,211.7	3,197.7	3,226.3	3,304.7	3,264.6	3,308.0	3,348.1	3,376.9	3,467.1	3,409.8	3,451.6	3,488.6	3,520.3
Broadband customers	752.6	752.6	715.4	656.1	656.1	603.1	547.8	502.4	450.4	450.4	407.2	359.3	314.2
Net broadband additions	96.5	37.3	59.2	205.8	53.0	55.3	45.5	52.0	184.2	43.2	47.8	45.2	48.0
<i>YOY change in broadband customers</i>	37.39%	37.39%	42.40%	45.69%	45.69%	48.11%	52.42%	59.84%	69.21%	69.21%	74.50%	74.02%	70.36%
Average revenue per customer per month (B)	\$78.01	\$79.41	\$76.60	\$74.74	\$77.23	\$74.29	\$73.14	\$72.60	\$71.84	\$72.76	\$72.64	\$71.06	\$70.90
Digital satellite television customers	150.2	150.2	122.3	87.7	87.7	61.5	42.8	29.1	9.3	9.3	0.3	-	-
Long distance customers	1,974.9	1,974.9	1,981.5	1,991.0	1,991.0	2,006.9	2,001.7	1,987.6	1,982.8	1,982.8	1,986.6	2,007.2	2,015.9
Consolidated:													
Capital expenditures	\$177.9	\$97.9	\$80.0	\$401.3	\$130.0	\$90.5	\$106.9	\$73.9	\$408.5	\$131.1	\$92.3	\$96.2	\$88.9
Reconciliation of Operating Income under GAAP to OIBDA from Current Businesses:													
Operating income under GAAP	\$ 562.4	\$ 292.8	\$ 269.6	\$ 898.9	\$ 285.7	\$ 254.0	\$ 185.3	\$ 173.9	\$ 633.8	\$ 168.2	\$ 162.2	\$ 151.2	\$ 152.2
Windstream Corporation													
Pro forma adjustments													
Wireline operating income adjustment for split off of directory publishing	(21.0)	(14.1)	(6.9)	(53.9)	(20.6)	(12.2)	(14.1)	(7.0)	(55.9)	(21.1)	(11.4)	(16.5)	(6.9)
Other operating income adjustment for split off of directory publishing	(2.7)	(4.7)	2.0	(10.7)	(6.4)	(0.5)	(4.9)	1.1	(9.1)	(5.0)	(0.9)	(3.8)	0.6
Valor Communications Group, Inc. operating income	-	-	-	80.9	-	(6.9)	43.5	44.3	167.0	43.2	41.3	44.9	37.6
Customer list amortization	-	-	-	(24.1)	-	(2.1)	(11.0)	(11.0)	(44.0)	(11.0)	(11.0)	(11.0)	(11.0)
Royalty expense	-	-	-	129.5	-	-	62.4	67.1	268.7	66.5	67.4	67.4	67.4
Restructuring and other charges	3.2	1.6	1.6	54.5	16.0	31.0	5.0	2.5	33.2	32.3	0.9	-	-
Discontinuance of SFAS No. 71	-	-	-	0.4	-	-	2.3	(1.9)	8.6	3.6	1.7	4.8	(1.5)
Adjusted operating income	541.9	275.6	266.3	1,075.5	274.7	263.3	268.5	269.0	1,002.3	276.7	250.2	237.0	238.4
Depreciation and amortization expense	252.0	126.9	125.1	517.5	123.9	130.3	130.2	133.1	596.8	138.5	149.3	153.6	155.4
Depreciation and amortization adjustment for split off of directory publishing	-	0.4	(0.4)	(1.6)	(0.4)	(0.4)	(0.4)	(0.4)	(1.6)	(0.4)	(0.4)	(0.4)	(0.4)
Pro forma OIBDA from current businesses (C)	\$ 793.9	\$ 402.9	\$ 391.0	\$ 1,591.4	\$ 398.2	\$ 393.2	\$ 398.3	\$ 401.7	\$ 1,597.5	\$ 414.8	\$ 399.1	\$ 390.2	\$ 393.4

(A) Pro forma results of operations from current businesses adjusts results of operations under Generally Accepted Accounting Principles ("GAAP") for the effects of the spin-off of the Alltel Corporation ("Alltel") wireline division and merger of that business with Valor Communications Group, Inc. (Valor), the discontinuance of SFAS No. 71 and the split off of its directory publishing business, as of January 1, 2005.
(B) Average revenue per customer per month is calculated by dividing total wireline revenues by average customers for the period.
(C) OIBDA is operating income before depreciation and amortization.