MANAGEMENT’S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following information should be read in conjunction with our selected combined financial and operating data and the accompanying combined financial statements and related notes. See “Index to Financial Statements and Financial Statement Schedule.” The following discussion may contain forward-looking statements that reflect our plans, estimates and beliefs. Our actual results could differ materially from those discussed in these forward-looking statements. Factors that could cause or contribute to these differences include, but are not limited to, those discussed below and elsewhere in this prospectus, particularly in “Risk Factors” and “Cautionary Statement Regarding Forward-Looking Statements.”

Our combined financial information may not be indicative of our future performance and does not necessarily reflect what our financial condition and results of operations would have been had we operated as a separate, stand-alone entity during the periods presented, particularly since many changes will occur in our operations and capitalization as a result of our spin-off from Sprint Nextel.

Overview

We are currently a subsidiary of Sprint Nextel. Sprint Nextel has determined to spin off our company by distributing all of our common stock to its stockholders as a dividend. We have entered into a separation and distribution agreement with Sprint Nextel containing the key provisions relating to the separation of our business from Sprint Nextel. The separation and distribution agreement identifies the assets to be transferred, liabilities to be assumed and contracts to be assigned to us. Our capital structure will be changed significantly at the date of the spin-off from Sprint Nextel.

Our operations consist mainly of regulated incumbent local phone companies operating in 18 states. We provide local voice and data services, including high-speed Internet, for customers within our local service territories. We also provide access to our local network and other wholesale communications services for other carriers, sales of communications equipment and other services to residential and business customers.

Key business factors that impacted the year ended December 31, 2005 include:

• Continued competition from wireless and cable providers negatively impacted revenue, operating income and total access lines in service. We expect access line loss to continue.

• We added nearly 201,000 new high-speed Internet lines in service increasing high-speed Internet revenues from $224 million for the year ended December 31, 2004 to $326 million for the year ended December 31, 2005.

• We entered into a new sales contract with a large communications company resulting in additional product distribution sales of $104 million.
Key business factors that are anticipated to impact our 2006 performance are summarized below. These estimates represent management’s judgment based on currently available information. A number of risks and uncertainties, including but not limited to, the impact of increased competition as well as the effectiveness of our response to that competition and our success in achieving growth targets concerning high-speed Internet lines in service could cause our actual results to differ materially from those presented below. See “Cautionary Statement Regarding Forward-Looking Statements.”

### Estimated Income from Continuing Operations Before Income Taxes

<table>
<thead>
<tr>
<th>Increase (Decrease)</th>
<th>(millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core Operations:</td>
<td></td>
</tr>
<tr>
<td>Continued competition from wireless providers and increased competition from cable providers are expected to drive increased levels of access line losses, which are anticipated to negatively impact revenue and income from continuing operations before income taxes.</td>
<td></td>
</tr>
<tr>
<td>Continued growth in high-speed Internet lines in service, partially offset by pricing incentives largely associated with bundled service offerings, is expected to generate increased data revenues. Up-front selling and installation costs will partially offset the impact of this increase in data revenues.</td>
<td></td>
</tr>
<tr>
<td>Product distribution sales are expected to decline as a result of the exit from certain markets and the spin off from Sprint Nextel. This is expected to have minimal impact on income from continuing operations before income taxes due to the low margins associated with this business.</td>
<td></td>
</tr>
<tr>
<td>Anticipated losses from wireless service offering attributable to up-front customer acquisition costs.</td>
<td></td>
</tr>
<tr>
<td>Anticipated productivity improvements across our business will partially offset the items presented above.</td>
<td></td>
</tr>
<tr>
<td>Estimated impact to 2006 performance</td>
<td>($150)–($210)</td>
</tr>
<tr>
<td>Spin-off Related(1):</td>
<td></td>
</tr>
<tr>
<td>Customer transfers (principally in-territory consumer and business long distance customers) and elimination of allocated charges from Sprint Nextel (e.g., merger and integration costs, asset impairments and return on investment charge) (2)</td>
<td>$210-$250</td>
</tr>
<tr>
<td>Increased costs resulting from our spin-off from Sprint Nextel (e.g., establishing our own corporate support functions consisting primarily of employee-related expenses) (3)</td>
<td>($80)</td>
</tr>
<tr>
<td>Incremental non-recurring separation costs</td>
<td>($100)</td>
</tr>
<tr>
<td>Incremental interest expense resulting from the issuance of $4.485 billion of notes and borrowings of $2.1 billion under our credit facility (4)</td>
<td>($460)</td>
</tr>
<tr>
<td>Elimination of interest expense on related-party notes</td>
<td>$25</td>
</tr>
</tbody>
</table>

(1) See “Unaudited Pro Forma Combined Financial Information.”
(2) 2006 impact will be dependent on the actual date of the spin-off.
(3) Estimated to be $100 million annually by 2008.
(4) 2006 impact will be dependent on the actual date of the spin-off and prevailing interest rates at that time.
The following factors are also expected to affect liquidity in 2006:

- Dividend payments to stockholders are anticipated to be approximately $300 million annually. If the spin-off occurs before June 30, 2006, our anticipated dividend payments to stockholders in 2006 will be approximately $150 million.

- Capital expenditures are anticipated to be approximately $960 million, including certain one-time capital expenditures associated with IT systems and other capabilities required to be created in order for Embarq to operate as a separate company.

**Planned Separation from Sprint Nextel**

On December 15, 2004, the boards of directors of Sprint and Nextel each unanimously approved a strategic merger combining Sprint and Nextel in a “merger of equals.” Upon completion of the merger on August 12, 2005, Sprint changed its name to Sprint Nextel Corporation and Sprint Nextel common stock is now quoted on the New York Stock Exchange under the symbol “S.” Previously existing shares of Sprint common stock remain outstanding as Sprint Nextel common stock, as Sprint was the acquiring entity for legal and accounting purposes.

When the merger was announced, Sprint also announced its intention to pursue the spin-off of the companies comprising our operations, after completion of the merger. The distribution, now expected to occur in the second quarter of 2006, will occur through a tax-free distribution by Sprint Nextel of all of the shares of our common stock to Sprint Nextel’s stockholders. The separation is subject to certain conditions including receipt of necessary state and federal regulatory approvals and our transfer to Sprint Nextel of cash and notes in the aggregate amount of approximately $6.6 billion in partial consideration for, and as a condition to, Sprint Nextel’s transfer to us of the local telecommunications division and wholesale product distribution operations and the consumer and certain business long distance customers located in our local service territories, as described below in “—New Financing Arrangements.” We anticipate we will incur separation and distribution related expenses associated with establishing ourselves as an independent company. These expenses are expected to be significant and will be expensed as incurred.

**Basis of Presentation**


Our combined financial statements were prepared using the specific financial accounting records of the entities that comprise the local communications business of Sprint Nextel, including the wholesale distribution of communication products. These combined financial statements have been presented using the historical results of operations and historical basis of assets and liabilities of these businesses. All intercompany transactions between these combined entities have been eliminated.

Our operations are divided into two segments, Local and Product Distribution. Our chief operating decision maker determines resource allocation and assesses financial performance based on these two segments. The Local segment includes local exchange voice services, access by phone customers and other carriers to our local network, high-speed Internet services and other data transport and special access services. The Product Distribution segment includes the wholesale distribution of communications equipment.

The combined financial statements are prepared using accounting principles generally accepted in the U.S. These principles require management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Actual results could differ from those estimates and assumptions. Additionally, the assets and liabilities included in our combined financial statements may differ from our assets and liabilities upon completion of the spin-off. The spin-off will be completed on the terms contained in the separation and
distribution agreement that we have entered into with Sprint Nextel. Our management believes that all historical costs of operations have been reflected in the combined financial statements.

We are also presenting unaudited pro forma combined financial information to reflect adjustments for and give effect to the transactions contemplated by the separation and distribution agreement as well as provide disclosures regarding actual and estimated one-time separation costs and with respect to the impact of our wireless commercial service agreement. See “Unaudited Pro Forma Combined Financial Information” included elsewhere in this prospectus.

New Financing Arrangements

In connection with the spin-off, we will enter into a credit facility with certain financial institutions. We expect to transfer to Sprint Nextel approximately $6.6 billion in the form of cash and the notes being offered by Sprint Capital under this prospectus in partial consideration for, and as a condition to, Sprint Nextel’s transfer to us of our business. The allocation of consideration is expected to result in the issuance to Sprint Nextel of the notes in an aggregate initial principal amount of approximately $4.5 billion and the transfer to Sprint Nextel of approximately $2.1 billion in cash borrowed under our credit facility. The credit facility will also provide a revolving credit arrangement, including letters of credit, to help satisfy other financing needs. We expect that the terms of our credit facility will include customary covenants that, among other things, will require us to satisfy certain financial tests, maintain certain financial ratios, restrict our ability to create liens, which could limit our ability to incur additional indebtedness, and restrict the ability of our subsidiaries to incur additional indebtedness. To the extent permitted, we may also incur additional indebtedness from time to time for general corporate purposes, including working capital requirements, capital expenditures and future acquisitions.

We anticipate that immediately following the distribution date, we will have combined cash and equivalents of $200 million and available liquidity under the credit facility of $1 billion. As a result of the borrowings to be incurred and paid to Sprint Nextel in partial consideration for our assets and existing borrowings of our subsidiaries, we will have approximately $7.25 billion of indebtedness on the distribution date.

Centralized Management and Allocations

Sprint Nextel uses a centralized cash management program, whereby Sprint Nextel advances funds to and from its subsidiaries. These advances are accounted for as short-term borrowings and bear interest at a market rate that is substantially equal to the rate the subsidiary would be able to obtain from third parties on a short-term basis. Following the spin-off, we will be responsible for our own cash management functions. Advance receivables with Sprint Nextel have been presented as “Cash and equivalents” for purposes of these historical combined financial statements. Advance payables with Sprint Nextel have been presented as “short-term borrowings.”

Sprint Nextel provides facilities, information services, marketing and certain corporate and administrative services to its subsidiaries, including our company. Sprint Nextel directly assigns, where possible, related costs based on actual use of these services. Where direct assignment is not possible or practical, Sprint Nextel uses other indirect methods, including time studies and headcounts, to estimate the allocation of shared service costs to its subsidiaries. The services provided by Sprint Nextel to its subsidiaries are generally accounted for based on fully distributed costs, which we believe approximates fair value. The costs allocated are not necessarily indicative of costs that will be charged or incurred in the future. Related party payables to Sprint Nextel resulting from the allocation of shared service costs are settled approximately one month after their initial recognition. Related party payables for purposes of historical combined financial statements have been presented as “Accounts payable.”

Following the spin-off, Sprint Nextel will continue to provide us with many of these services pursuant to a transition services agreement for a period of up to two years following the separation. We will also arrange to
procure other services pursuant to arrangements with third parties or through our own employees. We currently expect that the aggregate annual costs we will pay to Sprint Nextel under the transition services agreement for services that have historically been provided by Sprint Nextel will not differ significantly from the amounts reflected in our historical combined financial statements, which include charges for those services. We also expect that by 2008 our annual incremental costs resulting from the establishment of corporate support services for our business will be approximately $100 million. We expect to incur significant non-recurring costs before June 2006 to establish our new brand of approximately $48 million and information technology investment to create the underlying infrastructure to support our business functions of approximately $150 million.

As a separate company, we will no longer benefit from being included in Sprint Nextel’s insurance package and will be responsible for obtaining our own insurance. We currently estimate that our first annual property insurance premium, with a $10 million deductible, will be approximately $5 million. Factors contributing to this premium include (1) the concentration of our assets in windstorm areas, (2) the number of older buildings that we will own and (3) general property insurance market conditions following recent hurricanes, especially Hurricane Katrina in 2005. We could be subject to windstorm sublimits and/or aggregate limits that could potentially limit our insurance recovery in the future. Overall insurance market conditions will determine premiums paid in future years.

See Note 12 of the Notes to Combined Financial Statements for additional related party transaction information.

Business Environment

We operate in an industry that has been and continues to be subject to consolidation and dynamic change. In light of these changes in the communications industry, including bankruptcies, over-capacity and the highly competitive pricing environment in all communications sectors, we routinely assess the implications of these industry factors on our operations. These assessments may impact the future valuation of our long-lived assets and could have a material effect on our business, financial condition, liquidity and results of operations.

Critical Accounting Policies

The fundamental objective of financial reporting is to provide useful information that allows a reader to understand our business activities. To aid in that understanding, management has identified our “critical accounting policies.” These policies are considered “critical” because they have the potential to have a material impact on our combined financial statements, and because they require judgments and estimation due to the uncertainty involved in measuring, at a specific point in time, events that are continuous in nature.

Long-lived Asset Recovery.

A significant portion of our total assets are long-lived assets, consisting primarily of property, plant and equipment, or PP&E. Changes in technology or in our intended use of these assets, as well as changes in broad economic or industry factors, may cause the estimated period of use or the value of these assets to change.

Depreciable Lives of Assets. Estimates and assumptions are used both in setting depreciable lives and testing for recoverability of our long lived assets. Assumptions are based on internal studies of use, industry data on lives, recognition of technological advancements and understanding of business strategy. We perform annual internal studies to confirm the appropriateness of depreciable lives for each category of PP&E. These studies utilize models, which take into account actual usage, physical wear and tear, replacement history, and assumptions about technology evolution, and in certain instances actuarially-determined probabilities to calculate remaining lives of our asset base.
We believe that the accounting estimate related to the establishment of asset depreciable lives is a “critical accounting estimate” because: (1) it requires our management to make assumptions about technology evolution and competitive uses of assets, and (2) the impact of changes in these assumptions could be material to our financial position, as well as our results of operations. Management’s assumptions about technology and its future development require significant judgment because the timing and impacts of technology advances are difficult to predict, and actual experience has varied from previous assumptions and could continue to do so.

If our studies had resulted in a depreciable rate that was 5% higher or lower than those used in the preparation of our combined financial statements, recorded depreciation expense would have been impacted by approximately $58 million and $57 million for the years ended December 31, 2005 and 2004, respectively.

**PP&E and Definite Life Intangibles.** PP&E and definite life intangibles are evaluated for impairment whenever indicators of impairment exist. Accounting standards require that if an impairment indicator is present, we must assess whether the carrying amount of the asset is unrecoverable by estimating the sum of the future cash flows expected to result from the asset, undiscounted and without interest charges. If the carrying amount is more than the recoverable amount, an impairment charge must be recognized, based on the fair value of the asset.

We believe that the accounting estimate related to asset impairment is a “critical accounting estimate” because: (1) it requires management to make assumptions about future revenues and costs of sales over the life of the asset, (2) judgment is involved in determining the occurrence of a “triggering event” and (3) the impact that recognizing an impairment would have on our financial position, as well as our results of operations, could be material. Management’s assumptions about future revenues require significant judgment as actual revenues have fluctuated in the past and may continue to do so.

In estimating future revenues, we use our internal business forecasts. We develop our forecasts based on recent revenue data for existing products and services, planned timing of new products and services, and other industry and economic factors.

During the fourth quarter of 2005, Sprint Nextel terminated development and deployment of a network monitoring software application resulting in approximately $77 million in asset impairment charges to our business.

**Employee Benefit Plan Assumptions.**

Retirement benefits are a significant cost of doing business for us and yet represent obligations that will be settled far in the future. Retirement benefit accounting is intended to reflect the recognition of the future benefit costs over the employee’s expected tenure with us based on the terms of the benefit plans and the related investment and funding decisions. The accounting standards require that management make assumptions regarding such variables as the return on assets, the discount rate and future health care costs. Changes in these key assumptions can have a significant impact on the projected benefit obligation and periodic benefit cost incurred.

We believe that the accounting estimate related to retirement benefit accounting is a “critical accounting estimate” because: (1) it requires assumptions about discount rates, future health care costs, and future return on assets funding the obligation and (2) the impact that changes in actual performance versus these estimates would have on the projected benefit obligation reported on our balance sheet and the related benefit expense could be material.

In determining pension obligations, assumptions concerning market performance are required. Market performance has fluctuated in the recent past and could have continued volatility in the future. In selecting a discount rate, an independent actuary models a hypothetical portfolio of bonds rated AA- or better that produces cash flows matching the projected benefit payments of the plan. To determine the return on asset assumption, forward-looking estimates of the expected long-term returns for a portfolio invested in accordance with the target investment policy is used.
The assumptions associated with the employee benefit plans are made by Sprint Nextel's management, and while these assumptions are critical to the determination of estimates used in the plan accounting, the assessment of risk associated with an estimate differing from the actual events that may transpire must be assessed at the Sprint Nextel level. Following the spin-off, these assessments will be made by our management.

In determining post-retirement medical and life insurance benefit obligations, assumptions are made concerning the cost of health care, including the assumed medical inflation rate, and the discount rate. Again, as these plans are managed by Sprint Nextel's management, the assessment of risk associated with an estimate differing from the actual events that may transpire must be assessed at the Sprint Nextel level. Following the spin-off, these assessments will be made by our management.

**Income Taxes.**

Current income tax expense represents the amount of income taxes paid or currently payable to various taxing jurisdictions in which we operate. Inherent in the current provision for income taxes are estimates and judgments regarding the interpretations of tax regulations, the tax class life assigned to assets, and the timing of deferred tax asset and liability realization. The amount of income taxes we ultimately pay is subject to ongoing audits by federal and state taxing authorities. Our estimate for the potential outcome for any uncertain tax issues is highly judgmental. We believe we have adequately provided for any foreseeable outcome related to these matters. However, our future results may include adjustments to our estimated tax liabilities in the period the assessments are made or resolved. As a result, our effective tax rate may fluctuate on a quarterly basis.

The combined financial statements reflect certain amounts related to deferred tax assets and liabilities, which result from temporary differences between the assets and liabilities measured for financial statement purposes versus the assets and liabilities measured for tax return purposes. Management must assess the expected realizable future tax benefits of deferred tax assets and record any required valuation allowances. We maintained a $2 million valuation allowance in each of the periods presented. The valuation allowance relates to state net operating loss carryovers. Actual income taxes could vary from estimates due to changes in income tax laws, significant changes in the jurisdictions in which we operate or our ability to generate sufficient future taxable income.

We believe that the accounting estimate related to establishing deferred taxes is a “critical accounting estimate” because: (1) it requires management to make assessments about the timing of future events, including the probability of expected future taxable income and available tax planning opportunities, and (2) the impact that changes in actual performance as compared to these estimates could have on the realization of tax benefits as reported in our results of operations could be material. Management’s assumptions require significant judgment because actual performance has fluctuated in the past and may continue to do so.

We recorded income tax expense of $578 million for the year ended December 31, 2005 and we carried a net deferred tax liability of $1.3 billion at December 31, 2005. This amount includes approximately $1.5 billion in deferred tax liabilities, which is partially offset by a $281 million deferred tax asset. See Note 9 of the Notes to the Combined Financial Statements.

**Revenue Recognition Policies.**

We recognize operating revenues as services are rendered or as products are delivered to customers in accordance with SEC Staff Accounting Bulletin No. 104, Revenue Recognition. In connection with recording revenue, estimates and assumptions are required in determining the expected conversion of the revenue streams to cash collected. The revenue estimation process requires management to make assumptions based on historical results, future expectations, the economic and competitive environment, changes in the credit worthiness of our customers and other relevant factors. Changes in these key assumptions can have a significant impact on the projection of cash collected and the periodic revenue stream recognized.
We believe that the accounting estimates related to the establishment of revenue and receivable reserves and the associated provisions in the results of operations are “critical accounting estimates” because: (1) they require management to make assumptions about future billing adjustments for disputes with customers, unauthorized usage, future returns on asset sales and future access adjustments for disputes with CLECs and inter-exchange carriers, as well as the future economic viability of our customer base; and (2) the impact that changes in actual performance as compared to these estimates would have on the accounts receivable reported on our balance sheet and the results reported in our statements of operations could be material. In selecting these assumptions, we use historical trending of write-offs, industry norms, regulatory decisions and recognition of current market indicators about general economic conditions to assess the impact on collectibility of accounts.

If the revenue reserve balances for the years ended December 31, 2005 and 2004 were to be increased by 1%, our net operating revenues would be reduced approximately $1 million for each period. If the accounts receivable reserve estimates as a percentage of accounts receivable for the years ended December 31, 2005 and 2004 were increased by 1%, bad debt expense would increase approximately $7 million for each period.

Management believes the reserve estimate selected, in each instance, represents its best estimate of future outcomes, but the actual outcomes could differ from the estimate selected.

Results of Operations

For the year ended December 31, 2005, we produced strong growth in data revenues through our high-speed Internet offerings and strong growth in product distribution due to a significant new contract. We continued to be impacted by developing competition and product substitution that resulted in a decline in access lines and switched access minutes of use and therefore a decline in voice revenues.

In the fourth quarter of 2005, Sprint Nextel, in conjunction with our management, terminated development and deployment of a network management software application resulting in approximately $77 million in allocated asset impairment charges to our business.

For the year ended December 31, 2004, we recorded a $40 million restructuring charge representing severance, real estate and other costs associated with the overall Sprint Nextel organizational realignment.

Combined Operations

Year ended December 31, 2005 compared to year ended December 31, 2004.

<table>
<thead>
<tr>
<th>Years ended</th>
<th>December 31, 2005 (millions)</th>
<th>December 31, 2004 (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating revenues</td>
<td>$6,254</td>
<td>$6,139</td>
</tr>
<tr>
<td>Operating income</td>
<td>$1,552</td>
<td>$1,590</td>
</tr>
<tr>
<td>Operating margin</td>
<td>24.8%</td>
<td>25.9%</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$828</td>
<td>$975</td>
</tr>
</tbody>
</table>

**Net Operating Revenues.** Net operating revenues increased $115 million, or 2%, for 2005 as compared to 2004. Data revenues and Product Distribution revenues increased $150 million and $163 million, respectively, stemming from a 41% increase in high-speed Internet lines in service and a new Product Distribution contract. These increases were partially offset by a decrease of $154 million in voice revenues resulting from a 4% decrease in access lines and a $44 million reduction in other revenues. We ended 2005 with approximately 7.35 million switched access lines. The reduction in access lines was driven principally by losses to wireless and cable providers, along with broadband substitution.
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Operating income decreased $38 million, or 2%, for 2005 compared to 2004. The growth in net operating revenues discussed above was more than offset by increased costs of services and products of $171 million and increased restructuring and asset impairment costs of $39 million. The increase in costs of services and products was due to increased Product Distribution revenues. Partially offsetting these cost increases was a decrease of $64 million in selling, general and administrative expenses driven by cost containment initiatives.

Year ended December 31, 2004 compared to year ended December 31, 2003.

<table>
<thead>
<tr>
<th></th>
<th>December 31, 2004</th>
<th>December 31, 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating revenues</td>
<td>$6,139</td>
<td>$6,159</td>
</tr>
<tr>
<td>Operating income</td>
<td>$1,590</td>
<td>$1,616</td>
</tr>
<tr>
<td>Operating margin</td>
<td>25.9%</td>
<td>26.2%</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$975</td>
<td>$1,118</td>
</tr>
</tbody>
</table>

Net Operating Revenues. Net operating revenues decreased $20 million for the year ended December 31, 2004 compared to the year ended December 31, 2003. The decrease was due to lower voice revenue of $111 million and declines in equipment and other sales, which reduced other revenue by $57 million. We ended 2004 with 7.67 million switched access lines, a 3% decrease compared to the prior year. Product Distribution revenues increased $45 million, or 13%, for the year ended December 31, 2004 compared to the year ended December 31, 2003. The increase was due to growth in sales to third parties partially offset by lower sales to other Sprint Nextel subsidiaries.

Operating income decreased $26 million, or 2%, for the year ended December 31, 2004 compared to the year ended December 31, 2003. Reduced revenues, discussed above, resulted in a corresponding decrease of $2 million in costs of products and services. Increases in restructuring and asset impairment charges and selling, general and administrative costs more than offset this decrease.

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Year ended December 31, 2005 compared to year ended December 31, 2004.

Segmental Results of Operations

Local

<table>
<thead>
<tr>
<th>Years ended</th>
<th>December 31, 2005</th>
<th>December 31, 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating revenues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voice</td>
<td>$4,003</td>
<td>$4,157</td>
</tr>
<tr>
<td>Data</td>
<td>983</td>
<td>833</td>
</tr>
<tr>
<td>Other</td>
<td>705</td>
<td>749</td>
</tr>
<tr>
<td>Total net operating revenues</td>
<td>5,691</td>
<td>5,739</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costs of services and products</td>
<td>1,815</td>
<td>1,814</td>
</tr>
<tr>
<td>Selling, general and administrative</td>
<td>1,226</td>
<td>1,298</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>982</td>
<td>967</td>
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<tr>
<td>Restructuring and asset impairment</td>
<td>79</td>
<td>40</td>
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<tr>
<td>Total operating expenses</td>
<td>4,102</td>
<td>4,119</td>
</tr>
<tr>
<td>Operating income</td>
<td>$1,589</td>
<td>$1,620</td>
</tr>
<tr>
<td>Operating margin</td>
<td>27.9%</td>
<td>28.2%</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$850</td>
<td>$999</td>
</tr>
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</table>

Voice Revenues. Voice revenues, consisting of revenue from local communication services, and access by phone customers and other carriers to our local network, decreased $154 million, or 4%, for the year ended December 31, 2005. This results from both a decrease in access lines and lower access minutes of use. Access lines decreased from 7.67 million lines at December 31, 2004 to 7.35 million lines at December 31, 2005 accounting for $63 million of the decrease. Switched access minutes of use in 2005 decreased 7% compared to 2004 resulting in a $38 million decrease in revenues. Additionally, FCC-allowable cost recoveries associated with local number portability ceased in 2004 causing a $6 million decrease in voice revenues for 2005. Recoveries for the cost of pooling local telephone numbers ceased in 2004 causing a decrease of $18 million. The wireless local number portability, or WLNP, charges that started in 2004 and ended in 2005 caused a decrease of $16 million.

Data Revenues. Data revenues are mainly generated from high-speed Internet, local data transport services and special access. Data revenues increased $150 million, or 18%, for the year ended December 31, 2005 compared to the year ended December 31, 2004. This increase was driven by strong growth in high-speed Internet lines in service and special access sales primarily to wireless companies. We ended 2005 with 693,000 high-speed Internet lines in service, an increase of 41% compared to December 31, 2004.

Other Revenues. Other revenues are primarily generated from maintenance agreements, professional services agreements, sales agency relationships and the sale of communications equipment. Other revenues declined $44 million, or 6%, during the year ended December 31, 2005. This decrease was due to a de-emphasis of business equipment sales, which accounted for approximately $21 million of the decrease, and elimination of some sales agency agreements, which accounted for approximately $16 million of the decrease.

Costs of Services and Products. Costs of services and products include costs to operate and maintain our network. These costs were comparable year over year. Increases in labor strike costs of $5 million and increased
network charges related to the expansion of high-speed Internet of $9 million were offset by a $19 million year-over-year decline in hurricane-related expenses. Costs of services and products were 32% of net operating revenues for the years ended December 31, 2005 and 2004.

**Selling, General and Administrative Expense.** Selling, general and administrative, or SG&A, expense decreased $72 million, or 6%, for the year ended December 31, 2005 compared to the year ended December 31, 2004. The decrease was due to cost containment initiatives, which resulted in $73 million in lower allocated costs and reduced information technology costs of approximately $60 million. These reductions were partially offset by $51 million in allocated merger, integration and spin-off related costs. SG&A expense was 22% of net operating revenues for the year ended December 31, 2005 compared to 23% for the year ended December 31, 2004.

SG&A expense includes charges for estimated bad debt expense. The reserve for bad debt requires management’s judgment and is based on historical trending, industry norms and recognition of current market indications regarding general economic conditions. Bad debt expense as a percentage of net revenues was 1% for the years ended December 31, 2005 and 2004. The reserve for bad debt as a percent of outstanding accounts receivable was 8% at December 31, 2005 and 9% at December 31, 2004.

**Depreciation and Amortization Expense.** Depreciation and amortization expense increased $15 million, or 2%, for the year ended December 31, 2005 compared to the year ended December 31, 2004. Approximately $5 million of the increase was due to increased plant investment. The remainder of the increase was due to the annual remaining life depreciation rate update process. As part of the depreciation rate update process, depreciation rates were increased for digital switching equipment and metallic cable, while other items had minor adjustments. The rate updates resulted in increased depreciation expense of $10 million for 2005. Depreciation and amortization expense was 17% of net operating revenues for each of the years ended December 31, 2005 and 2004.

**Restructuring and Asset Impairments.** In 2005, we recorded $79 million in restructuring and asset impairment costs. Sprint Nextel, in conjunction with our management, terminated development and deployment of a network management software application resulting in approximately $77 million in allocated asset impairment charges. The project was terminated after evaluating business strategies as it was determined that the project would not provide the cost structure, flexibility or operational functionality we would need once the spin-off is complete.

For the year ended December 31, 2004, we recorded a $40 million restructuring charge representing severance, real estate and other costs associated with the overall Sprint Nextel organizational realignment.

See Note 5 of the Notes to the Combined Financial Statements for additional information regarding restructuring and impairment charges.

**Capital Expenditures.** For the year 2005 compared to the year 2004, capital expenditures decreased by $149 million, or 15%, resulting from increased capital efficiency achieved primarily by tighter capacity management, vendor cost reductions and successful execution of equipment re-use opportunities. Capacity spending reductions represented 76% of the decrease, with regulatory mandates and operational requirements representing the remainder.
### Year ended December 31, 2004 compared to year ended December 31, 2003.

<table>
<thead>
<tr>
<th></th>
<th>December 31, 2004 (millions)</th>
<th>December 31, 2003 (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net operating revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voice</td>
<td>$4,157</td>
<td>$4,268</td>
</tr>
<tr>
<td>Data</td>
<td>833</td>
<td>730</td>
</tr>
<tr>
<td>Other</td>
<td>749</td>
<td>806</td>
</tr>
<tr>
<td><strong>Total net operating revenues</strong></td>
<td>$5,739</td>
<td>$5,804</td>
</tr>
<tr>
<td><strong>Operating expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costs of services and products</td>
<td>1,814</td>
<td>1,854</td>
</tr>
<tr>
<td>Selling, general and administrative</td>
<td>1,298</td>
<td>1,285</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>967</td>
<td>983</td>
</tr>
<tr>
<td>Restructuring and asset impairments</td>
<td>40</td>
<td>24</td>
</tr>
<tr>
<td><strong>Total operating expenses</strong></td>
<td>$4,119</td>
<td>$4,146</td>
</tr>
<tr>
<td><strong>Operating income</strong></td>
<td>$1,620</td>
<td>$1,658</td>
</tr>
<tr>
<td><strong>Operating margin</strong></td>
<td>28.2%</td>
<td>28.6%</td>
</tr>
<tr>
<td><strong>Capital expenditures</strong></td>
<td>$999</td>
<td>$1,143</td>
</tr>
</tbody>
</table>

**Voice Revenues.** Voice revenues decreased $111 million, or 3%, for 2004 due to a decrease in access lines, which reduced revenues by approximately $53 million. Additionally, FCC-allowable cost recoveries associated with local number portability ceased in 2004 causing a $42 million decrease in voice revenues. Recoveries for the cost of pooling local telephone numbers ceased in 2004 causing a decrease of $18 million in 2005, which was offset by an increase of $18 million in WLNP charges which started in July 2004.

**Data Revenues.** Data revenues increased $103 million, or 14%, during 2004 as a result of strong growth in high-speed Internet services. We ended 2004 with 492,000 high-speed Internet lines in service, an increase of 62% compared to the end of 2003.

**Other Revenues.** Other revenues decreased $57 million, or 7%, during 2004, principally driven by a decline in business equipment sales of $38 million. The decrease in equipment sales was a result of both a planned shift in focus to selling higher margin products as well as a reduction in customer demand. Additionally, we moved to a sales agency relationship for PCS handsets rather than taking ownership of the handsets, thereby reducing revenue by approximately $28 million.

**Costs of Services and Products.** Costs of services and products decreased $40 million, or 2%, during 2004. General expense controls within the information technology and support organizations resulted in approximately $35 million of savings. Additionally, lower costs of $18 million and $29 million associated with business equipment sales and PCS handset sales, respectively, were partially offset by a $25 million increase in hurricane-related expenses and $14 million in associated consumer equipment expenses. Costs of services and products were 32% of net operating revenues for both 2004 and 2003.

**Selling, General and Administrative Expense.** SG&A expense increased $13 million, or 1%, during 2004 compared to 2003. The increase was driven by $29 million in stock-based compensation expense, recoveries of bad debts in 2003 of $35 million that did not recur in 2004 and other various increases totaling approximately $19 million. These increases were partially offset by general cost controls within the information technology and support organizations of approximately $70 million. Bad debt expense as a percentage of net revenues was 1% for both the year ended December 31, 2004 and the year ended December 31, 2003. The reserve for bad debt expense as a percent of outstanding accounts receivable was 9% at December 31, 2004 and 2003.

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SG&A expense was 23% of net operating revenues for the year ended December 31, 2004 and 22% for the year ended December 31, 2003.

**Depreciation and Amortization Expense.** Depreciation and amortization expense decreased $16 million, or 2%, year over year, and was 17% of net operating revenues for each of the years ended December 31, 2004 and 2003. Effective January 1, 2003, we adopted Statement of Financial Accounting Standards, or SFAS No. 143, Accounting for Asset Retirement Obligations, which eliminated the accrual for removal cost from the depreciable rate. For further information on the implementation of SFAS No. 143, see Note 4 of the Notes to Combined Financial Statements.

**Restructuring and Asset Impairment.** For the years ended December 31, 2004 and 2003, we recorded approximately $40 million and $20 million, respectively, of severance costs associated with the Sprint Nextel organizational realignment.

During the year ended December 31, 2003, Sprint Nextel terminated deployment of its Insight video service resulting in our recognition of approximately $5 million in asset impairment charges.

For additional discussion of restructuring and asset impairments, see Note 5 of the Notes to Combined Financial Statements.

**Capital Expenditures.** Capital expenditures decreased by $144 million, or 13%, in 2004 compared to 2003 as we changed our network deployment guidelines and engineering standards.

**Product Distribution**

*Year ended December 31, 2005 compared to year ended December 31, 2004.*

<table>
<thead>
<tr>
<th>Years ended</th>
<th>December 31, 2005</th>
<th>December 31, 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating revenues</td>
<td>(millions)</td>
<td></td>
</tr>
<tr>
<td>Third party</td>
<td>$509</td>
<td>$341</td>
</tr>
<tr>
<td>Related party</td>
<td>54</td>
<td>59</td>
</tr>
<tr>
<td>Intercompany</td>
<td>386</td>
<td>450</td>
</tr>
<tr>
<td>Total net operating revenues</td>
<td>949</td>
<td>850</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costs of products</td>
<td>850</td>
<td>745</td>
</tr>
<tr>
<td>Selling, general and administrative</td>
<td>112</td>
<td>104</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>21</td>
<td>22</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>983</td>
<td>871</td>
</tr>
<tr>
<td>Operating loss</td>
<td>$34</td>
<td>$21</td>
</tr>
<tr>
<td>Operating margin</td>
<td>(3.6)%</td>
<td>(2.5)%</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$5</td>
<td>$2</td>
</tr>
</tbody>
</table>

**Net Operating Revenues.** Product distribution revenues consist of sales to third parties, sales to related parties, consisting of Sprint Nextel entities other than us, and intercompany sales, consisting of sales to our Local segment. Product distribution revenues increased $99 million, or 12%, in 2005 compared to 2004, driven by higher equipment sales to third parties. Of the $168 million increase in sales to third parties, $104 million, or 62%, was due to a significant new contract with a large communications company. Partially offsetting third-party
sales were decreases of $5 million in related party revenues and $64 million in intercompany sales, which were caused by lower capital expenditures by the Local segment and related parties.

Costs of Products. Costs of products include costs of equipment sold. These costs increased $105 million, or 14%, during 2005 compared to 2004. The increase was driven by the increase in sales to third parties. Costs of products were 90% of net operating revenues for 2005 compared to 88% for 2004.

Selling, General and Administrative Expense. SG&A expense increased $8 million, or 8%, for 2005 compared to 2004. The increase was due to increased business selling costs associated with increased third party sales. SG&A expense was 12% of net operating revenues for both 2005 and 2004.

SG&A expense includes charges for estimated bad debt expense. The reserve for bad debt requires management’s judgment and is based on historical trending, industry norms and recognition of current market indications regarding general economic conditions. Bad debt expense was approximately $1 million for the years ended December 31, 2005 and 2004. The reserve for bad debt as a percent of outstanding third and related party accounts receivable was 4% at December 31, 2005 compared to 5% at December 31, 2004.

Year ended December 31, 2004 compared to year ended December 31, 2003.

<table>
<thead>
<tr>
<th>Years ended</th>
<th>December 31, 2004 (millions)</th>
<th>December 31, 2003 (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net operating revenues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Third party</td>
<td>$341</td>
<td>$290</td>
</tr>
<tr>
<td>Related party</td>
<td>59</td>
<td>65</td>
</tr>
<tr>
<td>Inter-company</td>
<td>450</td>
<td>485</td>
</tr>
<tr>
<td>Total net operating revenues</td>
<td>850</td>
<td>840</td>
</tr>
<tr>
<td>Operating expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Costs of products</td>
<td>745</td>
<td>743</td>
</tr>
<tr>
<td>Selling, general and administrative</td>
<td>104</td>
<td>104</td>
</tr>
<tr>
<td>Depreciation and amortization</td>
<td>22</td>
<td>23</td>
</tr>
<tr>
<td>Restructuring and asset impairments</td>
<td>—</td>
<td>1</td>
</tr>
<tr>
<td>Total operating expenses</td>
<td>871</td>
<td>871</td>
</tr>
<tr>
<td>Operating loss</td>
<td>$21</td>
<td>$31</td>
</tr>
<tr>
<td>Operating margin</td>
<td>(2.5)%</td>
<td>(3.7)%</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>$2</td>
<td>$1</td>
</tr>
</tbody>
</table>

Net Operating Revenues. Product Distribution revenues increased $10 million, or 1%, for 2004 compared to 2003. The increase was due to growth in sales to third party customers partially offset by lower sales to related parties and inter-company sales. Sales to third parties increased due to increases in capital spending in the communications industry. The decreases in related party and intercompany revenues were a result of both a planned shift in focus to selling higher margin products and a reduction in customer demand.

Costs of Products. Costs of products were comparable year over year. Consistent with sales, costs of products reflected the planned shift in focus to selling higher margin products and a reduction in customer demand for equipment. Costs of products were 88% of net operating revenues for each of the years ended December 31, 2004 and 2003.

Selling, General and Administrative Expense. SG&A expense was comparable year over year. Pension cost and stock-based compensation expense increased approximately $2 million each, but were offset by general cost
controls. Bad debt expense as a percentage of net revenues was not significant in either year. The reserve for bad debt expense as a percent of outstanding third and related party accounts receivable was 5% at December 31, 2004 compared to 8% at December 31, 2003.

SG&A expense was 12% of net operating revenues for both 2004 and 2003.

Restructuring and Asset Impairment. For the year ended December 31, 2003, we recorded approximately $1 million of severance costs associated with the Sprint Nextel organizational realignment.

Nonoperating Items

Interest Expense

The effective interest rates in the following table reflect interest expense on long-term debt only. Interest costs on short-term borrowings and interest costs on deferred compensation plans have been excluded so as not to distort the effective interest rates on long-term debt.

<table>
<thead>
<tr>
<th>Years ended December 31,</th>
<th>2005</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective interest rate on long-term debt</td>
<td>7.7%</td>
<td>7.6%</td>
<td>7.6%</td>
</tr>
</tbody>
</table>

Our effective interest rate on long-term debt increased for the year ended December 31, 2005 primarily due to the retirement of debt with lower interest rates. Historical interest expense on long-term debt is not representative of anticipated interest expense that will be incurred after our spin-off from Sprint Nextel, as it does not reflect the level of borrowing that our business will assume upon the spin-off. For more information on our financing activities, see “—Liquidity and Capital Resources.”

Premium on Early Retirement of Debt

There were no early retirements of debt in either 2005 or 2004. Premiums on the early retirement of debt of $5 million were incurred in 2003. See Note 6 of the Notes to Combined Financial Statements for more information.

Income Taxes

Our combined effective tax rate was 39.3% for the year ended December 31, 2005. The combined effective tax rate was 38.3% for the year ended December 31, 2004 and 38.2% for the year ended December 31, 2003. See Note 9 of the Notes to Combined Financial Statements for a reconciliation of the effective income tax rates to the statutory federal rate for income taxes related to continuing operations.

Discontinued Operations, Net

In 2002, Sprint Nextel signed a definitive agreement to sell its directory publishing business to R.H. Donnelley for $2.23 billion in cash. The sale, which closed in January 2003, included Centel Directories Company, or CDC, a wholly owned subsidiary of Centel, which is included in our company. In connection with the sale in 2003, we received $647 million in cash, recognized a pre-tax gain of $635 million ($375 million after tax) and, up to the date of sale, recognized $1 million after tax from the results of operations.

Cumulative Effect of Changes in Accounting Principle, Net

The Financial Accounting Standards Board, or FASB, Interpretation No. 47, or FIN 47, was issued in 2005, interpreting the application of SFAS No. 143 (see discussion of SFAS No. 143 below). FIN 47 requires the
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recognition of a liability for legal obligations to perform an asset retirement activity in which the timing and/or method of the settlement are conditioned on a future event. We adopted FIN 47 in the fourth quarter of 2005, which resulted in the recognition of an asset retirement obligation, or ARO, liability of $28 million, an ARO asset of $4 million and a cumulative effect of change in accounting principles, net of tax of $16 million. The ARO liability is included in “Other noncurrent liabilities” and the ARO asset is included in “Property, plant and equipment” on the Combined Balance Sheets. An ARO liability was established for the estimated cost of removal and disposal of asbestos in company-owned buildings, removal and environmental clean-up of standby power supply system fuel storage tanks and decommissioning of leased buildings for which estimated settlement can be reasonably determined. An ARO liability was not recognized for easements and rights-of-way granted by the United States government, municipalities and private landowners used to route our above-ground and buried cable facilities because the estimated settlement dates of these obligations is indeterminable.

The following table, with comparable actual amounts for the years ended December 31, 2004 and 2003, sets forth the pro forma effects on net income and other noncurrent liabilities assuming we had adopted the provisions of FIN 47 during all periods affected.

<table>
<thead>
<tr>
<th>Years Ended December 31,</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>As reported</td>
<td>$917</td>
<td>$1,554</td>
</tr>
<tr>
<td>Pro forma amounts reflecting the accounting change applied retroactively</td>
<td>$915</td>
<td>$1,552</td>
</tr>
<tr>
<td>Other noncurrent liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>As reported</td>
<td>$ 57</td>
<td>$ 65</td>
</tr>
<tr>
<td>Pro forma amounts reflecting the accounting change applied retroactively</td>
<td>$ 83</td>
<td>$ 90</td>
</tr>
</tbody>
</table>

Consistent with regulatory requirements and industry practice, we historically accrued costs of removal of telephone poles, conduit and cable in its depreciation reserve. Adoption of SFAS No. 143, Accounting for Asset Retirement Obligations, affected the cost we historically recorded as these costs of removal did not meet the standard’s definition of an Asset Retirement Obligation. Upon adoption of SFAS No. 143, we recorded a reduction in our historical depreciation reserves of approximately $420 million to remove the accumulated excess cost of removal. This resulted in a cumulative effect of change in accounting principle credit, net of tax, of $258 million.

Financial Condition

Our combined assets of approximately $9.2 billion at December 31, 2005 reflected a decrease of $108 million from our combined assets at December 31, 2004. Cash and equivalents, which include net advance receivables from Sprint Nextel of $103 million and $113 million at December 31, 2005 and 2004, respectively, decreased $10 million as capital expenditures, debt payments and dividend payments to Sprint Nextel exceeded cash provided by operations. Inventories increased $8 million to support a new product distribution contract entered into in 2005. Net PP&E decreased $173 million at December 31, 2005 as depreciation expense exceeded capital expenditures.

Accounts payable, which includes $263 million and $140 million of related party payables at December 31, 2005 and 2004, respectively, increased $117 million, or 28%, due to the allocation of asset impairments and allocated merger integration and costs related to the spin-off. Long-term debt including current maturities decreased by $115 million due to the payment of regularly scheduled debt maturities. The deferred tax liability increased by $21 million primarily because of increases in the book to tax differences in PP&E. Postretirement and other benefit obligations decreased by $41 million due primarily to payments for benefits being greater than additional accrued costs.
Our debt-to-total-capital ratio was 19% as of December 31, 2005 versus 20% at December 31, 2004. This decrease primarily reflects a decrease in total business equity of $108 million as dividend payments to Sprint Nextel exceeded net income for the period. Offsetting this was a decrease in debt of $115 million due to payments on scheduled maturities. Our historical debt to capital ratio is not representative of our anticipated ratio following the spin-off. For further discussion of our anticipated capital structure, see “—Liquidity and Capital Resources—Liquidity” below.

Liquidity and Capital Resources

We manage our liquidity and capital resource needs primarily through prioritizing the use of capital and timing and amount of capital expenditures.

Operating Activities

Net cash provided by operating activities of $1.9 billion decreased $160 million for the year ended December 31, 2005 compared to the year ended December 31, 2004 and was driven primarily by an increase in cash paid for taxes of $141 million.

Our cash flows provided by operating activities was approximately $2.1 billion for the year ended December 31, 2004 compared to approximately $1.8 billion for the year ended December 31, 2003, an increase of $260 million. Net income was $637 million higher in 2003 than in 2004, but was comparable when the non-operating items of $376 million for discontinued operations and $258 million for the cumulative effect of changes in accounting principle were removed. The 2004 operating cash flows increased primarily due to higher deferred income and a decrease in the inventory and other current assets balances.

Investing Activities

Net cash used in investing activities totaled $816 million, $962 million and $452 million for the years 2005, 2004 and 2003, respectively. Capital expenditures account for the majority of our investing activities. Capital expenditures were primarily incurred to accommodate voice grade equivalent growth, convert the network from circuit to packet switching, continue the build-out of high-speed Internet services and to meet regulatory requirements.

In 2003, investing activities included $647 million of proceeds related to the sale of our directory publishing business. The overall decrease in capital expenditures for the year ended December 31, 2004 compared to the year ended December 31, 2003 was driven by reduced expenditures for capacity, operational maintenance, major projects, and the partial delay of the conversion from circuit to packet switching. These decreases were slightly offset by increased expenditures in high-speed Internet services build-out.

Financing Activities

Our cash flows used by financing activities totalled $1.1 billion and $1.0 billion for the years ended December 31, 2005 and 2004, respectively. Debt payments and dividends to Sprint Nextel accounted for the majority of our financing activities. Dividend payments to Sprint Nextel increased by $118 million and payments of scheduled debt maturities decreased $37 million for the year ended December 31, 2005 compared to the year ended December 31, 2004.

Our cash flows used by financing activities totaled approximately $1.0 billion and $1.3 billion for the years ended December 31, 2004 and 2003, respectively. For the year ended December 31, 2004, financing activities included a $152 million reduction in debt compared with a net reduction of $640 million for the year ended December 31, 2003. The debt reduction during the year ended December 31, 2004 was due to payments of scheduled maturities. For the year ended December 31, 2003, debt payments were made for short-term
borrowings, scheduled maturities and the early retirement of $84 million in callable bonds. In 2003, we moved from a net advance payable position, which is classified as short-term borrowings, to a net advance receivable position, which is classified as cash, because cash generated from operating activities combined with proceeds from the divestiture of the directory business was sufficient to fund our cash needs. Total borrowings, as presented in the historical combined financial statements, are not representative of the debt or cash that we expect to assume or incur upon the spin-off. Historically, Sprint Nextel has centrally managed its financing activities in order to optimize its costs of funding and financial flexibility at a corporate level. Consequently, the debt reflected in our historical combined financial statements does not necessarily reflect our debt capacity and financing requirements. For further discussion of our anticipated capital structure, see “—Liquidity” below.

We paid dividends to Sprint Nextel of $983 million in 2005 and $865 million in 2004. We will establish our own dividend policy following the spin-off. For further discussion of our anticipated dividend policy, see “—Liquidity” below.

Capital Requirements

Our investing activities are targeted primarily towards increased network capacity and include investments for growth in demand for high-speed Internet services, regulatory mandates and the phased transition from circuit to packet switching. Our anticipated 2006 capital expenditures will be approximately $960 million. This includes approximately $80 million of capital expenditures related to the spin-off. We expect capital expenditures before June 1, 2006 will be approximately $355 million. We continue to review closely capital expenditure requirements and will adjust spending and capital investment in response to customer demand.

Liquidity

We participate in Sprint Nextel’s cash management program, whereby Sprint Nextel advances funds to and from its subsidiaries. Sprint Nextel has used the proceeds from operations, the long-term bond market as well as other financial markets to fund capital needs. Additionally, we have our own long-term debt totaling $1,125 million and $1,240 million as of December 31, 2005 and December 31, 2004, respectively, made up of first mortgage bonds, debentures and related party notes. Our ability to fund our capital needs will be impacted by our ongoing ability to generate cash from operations, overall capacity and terms of our bank notes, term debt and access to the equity markets, which will be limited by our tax sharing agreement with Sprint Nextel. Given the volatility in the markets, we continue to monitor the markets closely and take steps to maintain financial flexibility and a reasonable capital structure.

Current debt maturities as of December 31, 2005 and December 31, 2004 were $2 million and $115 million, respectively. Our cash flow from operations for the year ended December 31, 2005 and the year ended December 31, 2004 adequately funded these requirements.

We have a letter of credit facility that is currently guaranteed by Sprint Nextel for an amount not to exceed $11 million. At December 31, 2005, we had outstanding letters of credit under this arrangement of approximately $1 million. Sprint Nextel has other letters of credit with various financial institutions that are available to various Embarq companies. On completion of the spin-off, none of Embarq’s letters of credit will be guaranteed by Sprint Nextel as they will be supported by the credit facility discussed below.

We are currently in compliance with all debt covenants associated with our borrowings.

Effective as of the distribution date, we will enter into a credit facility with certain financial institutions.

The credit facility is expected to consist of a revolving facility and a term loan, each with a term of five years. The credit facility is also expected to provide for the issuance of letters of credit within a sublimit.
The credit facility is expected to bear interest, at our option, at either (1) a fluctuating index rate plus the applicable margin or (2) a periodic fixed rate equal to LIBOR plus the applicable margin set forth in a pricing grid in the agreement. The applicable margin is expected to be based on our long-term senior unsecured non-credit-enhanced debt ratings. The credit facility is expected to include a facility fee and letter of credit fees, the amount of which will vary based on our debt ratings.

The credit facility is expected to include financial covenants requiring the maintenance of specified ratios of consolidated earnings before interest, taxes, depreciation and amortization, or EBITDA (as defined therein), to consolidated interest expense and consolidated debt to consolidated EBITDA. In addition, the credit facility is expected to contain customary affirmative and negative covenants, including covenants limiting our ability to:

- enter into transactions with affiliates;
- incur liens;
- incur debt at the subsidiary level;
- permit our subsidiaries to enter into agreements that limit their ability to declare or pay dividends, or to repay or prepay debt owed to, make loans or advances to, provide guaranties in respect of, transfer assets to or invest in, use or our subsidiaries; and
- engage in mergers, consolidations, asset sales or similar transactions.

The credit facility is also expected to contain customary events of default, including for failure to pay principal or interest when due, change of control, covenant defaults, cross-default and cross-acceleration with respect to other debt with a principal amount outstanding aggregating at least $100 million, the existence of unstayed or unsatisfied judgments or orders for payment of money in excess of $20 million individually or $100 million in the aggregate, certain events of bankruptcy and insolvency and certain events under ERISA.

Any downgrade in our credit ratings will increase our borrowing costs under the credit facility. Any downgrade could also restrict our access to the capital markets, increase our borrowing costs under new credit facilities and otherwise adversely affect the terms of future borrowings by, among other things, increasing the scope of our debt covenants and decreasing our financial or operating flexibility. The credit facility does not include any rating triggers that would allow the lenders involved to terminate the facility or accelerate maturity dates in the event of a credit rating downgrade.

We expect to transfer to Sprint Nextel approximately $6.6 billion in the form of cash and the notes being offered by Sprint Capital under this prospectus in partial consideration for, and as a condition to, Sprint Nextel’s transfer to us of our business. We currently expect that we will issue to Sprint Nextel notes in an aggregate initial principal amount of approximately $4.5 billion and transfer to Sprint Nextel approximately $2.1 billion in cash borrowed under our credit facility. The incurrence of this new indebtedness is conditioned on the completion of the spin-off. Including these borrowings and existing borrowings of our subsidiaries, we will have approximately $7.25 billion of indebtedness on the distribution date. We anticipate that immediately following the distribution date, we will have combined cash and equivalents of $200 million and available liquidity under the credit facility of $1 billion. To the extent permitted, we may also incur additional indebtedness from time to time for general corporate purposes, including working capital requirements, capital expenditures and future acquisitions. Regulatory restrictions and the terms of our indebtedness, however, limit our ability to raise capital through our subsidiaries, pledge the stock of our subsidiaries, encumber the assets of our subsidiaries and cause our subsidiaries to guarantee our indebtedness. In the separation and distribution agreement, we and Sprint Nextel have set a target of approximately $183 million for working capital (as defined in the separation and distribution agreement) on our opening balance sheet. See “Agreements with Sprint Nextel—Separation and Distribution Agreement—Further Action.”
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We expect to pay a regular quarterly dividend beginning in the third quarter of 2006. We currently expect the dividend to be in the aggregate amount of approximately $75 million in each full quarter. Our ability to fund a regular quarterly dividend will be impacted by our ongoing ability to generate cash from operations. Following the spin-off, payments on approximately $7.25 billion of indebtedness and our quarterly dividends will account for the majority of our financing activities. The declaration and payment of future dividends to holders of our common stock will be at the discretion of our board of directors, and will depend upon many factors, including our financial condition, earnings, growth prospects, funding requirements, applicable law and other factors our board of directors deems relevant. See “Unaudited Pro Forma Combined Financial Information.”

The following information presents the significant estimated changes in both recurring and non-recurring sources and uses of cash anticipated as a result of our spin-off. The recurring sources and uses presented below reflect the estimated annual impact, commencing from the actual spin-off date.

These estimates represent our management’s judgment based on currently available information and involve a number of risks and uncertainties that could cause our actual results to differ materially. See “Cautionary Statement Regarding Forward-Looking Statements.”

<table>
<thead>
<tr>
<th>Estimated Changes in Sources (Uses)</th>
<th>(millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recurring:</td>
<td></td>
</tr>
<tr>
<td>Elimination of dividend payment to Sprint Nextel</td>
<td>$ 983</td>
</tr>
<tr>
<td>Elimination of payments to Sprint Nextel for use of capital and consumption of shared PP&amp;E</td>
<td>147</td>
</tr>
<tr>
<td>Operating cost of corporate support functions</td>
<td>(100)</td>
</tr>
<tr>
<td>Interest expense, net of interest savings on related-party notes</td>
<td>(437)</td>
</tr>
<tr>
<td>Dividend payment to our stockholders</td>
<td>(300)</td>
</tr>
<tr>
<td>Non-recurring separation costs expected to be incurred in 2006:</td>
<td>(    )</td>
</tr>
<tr>
<td>Operating costs</td>
<td>($100)</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>(76)</td>
</tr>
</tbody>
</table>

Although the significant estimated changes resulting from the spin-off as outlined above provide incremental cash to the business, our overall cash position in 2006 is expected to decline as a result of the key business factors identified above under “Overview.” We do not believe that such decline will adversely affect our operations or our ability to make our anticipated capital expenditures, pay interest on indebtedness or make our anticipated dividend payments.

Our contractual obligations as of December 31, 2005 are summarized below and are disclosed in further detail in Notes 3, 6 and 11 of the Notes to Combined Financial Statements.

<table>
<thead>
<tr>
<th>Payments due by Period as of December 31, 2005</th>
<th>Total</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>After 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Related party notes</td>
<td>$460</td>
<td>$120</td>
<td>$255</td>
<td>$85</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First mortgage bonds and debentures</td>
<td>665</td>
<td>99</td>
<td>2</td>
<td>2</td>
<td>523</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Estimated future interest payments</td>
<td>865</td>
<td>84</td>
<td>75</td>
<td>60</td>
<td>489</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating leases</td>
<td>67</td>
<td>14</td>
<td>8</td>
<td>8</td>
<td>6</td>
<td>19</td>
<td></td>
</tr>
<tr>
<td>Unconditional purchase obligations</td>
<td>33</td>
<td>25</td>
<td>6</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total contractual obligations</td>
<td>$2,090</td>
<td>$129</td>
<td>$259</td>
<td>$184</td>
<td>$79</td>
<td>$323</td>
<td>$1,116</td>
</tr>
</tbody>
</table>

55
Long term debt obligations reflected above reflect our historical debt level, which is not representative of the debt repayments that will actually be due under our new capital structure.

The following table presents our pro forma contractual obligations and assumes the delivery to Sprint Nextel of approximately $4.5 billion of notes and the transfer to Sprint Nextel of cash proceeds of approximately $2.1 billion from borrowings under our credit facility. The pro forma amounts assume this transaction occurred on December 31, 2005.

### Unconditional Purchase Obligations

<table>
<thead>
<tr>
<th>Payments due by Period as of December 31, 2005</th>
<th>Total (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes issued to Sprint Nextel</td>
<td>$4,485</td>
</tr>
<tr>
<td>Credit facility</td>
<td>2,100</td>
</tr>
<tr>
<td>First mortgage bonds and debentures</td>
<td>665</td>
</tr>
<tr>
<td>Estimated future interest payments</td>
<td>6,580</td>
</tr>
<tr>
<td>Operating leases</td>
<td>67</td>
</tr>
<tr>
<td>Unconditional purchase obligations</td>
<td>33</td>
</tr>
<tr>
<td><strong>Total contractual obligations</strong></td>
<td><strong>$13,930</strong></td>
</tr>
</tbody>
</table>

### Expected pension contributions are disclosed in Note 7 of the Notes to Combined Financial Statements and have not been included in unconditional purchase obligations.

### Off-Balance Sheet Financing

We do not participate in, secure or finance any unconsolidated, special purpose entities.

### Financial Strategies

#### Derivatives

We selectively enter into interest rate swap agreements to manage exposure to interest rate changes on our debt. We also control exposure to market risk by regularly monitoring interest rate positions under normal and stress conditions to ensure they do not exceed established limits.
At the distribution date, we plan to issue approximately $4.5 billion of notes to Sprint Nextel. Our interest rate on this debt is expected to be determined based on the prevailing market conditions at the time of issuance. Given the historical low interest rate environment and volatility in interest rates, we sought to limit our interest rate risk associated with our expected incurrence of new debt by entering into hedge transactions with external counterparties.

During the fourth quarter 2005, we executed swaption derivative contracts for a cumulative notional amount of $600 million. These swaption contracts will mitigate the interest rate variability of the first ten years’ semi-annual interest payments on the first $600 million of our anticipated debt issuance.

Also during the fourth quarter 2005, we entered into Treasury collars for a cumulative notional amount of $2.4 billion. These interest rate collars will mitigate the interest rate variability of the first ten years’ semi-annual interest payments on the next $2.4 billion of our anticipated debt issuance.

Both the swaption derivative contracts and the Treasury collars are cash flow hedges.

At the inception of each cash flow hedge, each hedge was tested for effectiveness in mitigating the interest rate variability risk and all were deemed effective. At December 31, 2005, we tested the effectiveness of each cash flow hedge, both prospectively and retrospectively, and determined the swaption contracts were no longer effective hedges resulting in a pretax charge of $3 million and a liability of $3 million. The Treasury collars were accounted for as cash flow hedges resulting in a $1 million pretax charge for their ineffectiveness and a $9 million unrealized holding loss, net of tax, and a liability of $15 million.

We expect to terminate the hedge on or about the date that the debt is issued or shortly thereafter, if it has not already matured. On termination, the accumulated other comprehensive income (loss) will be amortized as interest expense over the life of the debt. See Note 3 of the Notes to Combined Financial Statements for additional information regarding derivative investment activity.

Recently Issued Accounting Pronouncements

In December 2004, FASB issued SFAS No. 123R, Share-Based Payment. This statement requires an entity to recognize the cost of employee services received in share-based payment transactions, through the use of fair-value-based methods. This statement became effective for us as of January 1, 2006.

Sprint Nextel voluntarily adopted fair value accounting for share-based payments effective January 1, 2003, under SFAS No. 123, as amended by SFAS No. 148, using the prospective method. Upon adoption, we began recognizing our allocated share of the fair value of stock-based compensation for all grants, modifications or settlements made on or after January 1, 2003. Further, in connection with the tracking stock recombination (see Note 2 of the Notes to Combined Financial Statements), as required by SFAS No. 123, we recognized our allocated share of compensation cost resulting from the conversion of PCS stock options to FON stock options. Sprint Nextel accounted for this conversion as a modification and accordingly applied stock option expensing to FON stock options resulting from the conversion of PCS stock options granted before January 1, 2003.

The revised standard will require us to begin to recognize allocated compensation cost for unvested FON stock options granted before January 1, 2003, which were outstanding as of January 1, 2006. This requirement to recognize expense on additional unvested grants will not be significant to our combined financial statements.

In November 2004, the FASB issued SFAS No. 151, Inventory Costs—an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4. This statement requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current-period charges regardless of whether they meet the definition of abnormal provided in ARB 43, Chapter 4, Inventory Pricing. The statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of this standard will not have a material impact on our combined financial statements.
In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29. This statement eliminates the exception to fair value measurement in the exchange of similar productive assets and replaces it with a general exception for exchange transactions that do not have commercial substance. That standard indicates that an exchange does not have commercial substance if it is not expected to significantly change the cash flows of the reporting entity. This statement is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of this standard did not have a material impact on our combined financial statements.

In March 2005, the FASB issued FASB Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations, or FIN 47. FIN 47 requires an entity to recognize a liability for a legal obligation to perform an asset retirement activity in which the timing and/or method of the settlement are conditional on a future event. The liability must be recognized if the fair value of the liability can be reasonably estimated. This interpretation of SFAS No. 143, Accounting for Asset Retirement Obligation, is effective no later than the end of the first fiscal year ending after December 15, 2005. We adopted FIN 47 in the 2005 fourth quarter resulting in recognition of an ARO liability of $28 million, an ARO asset of $4 million and a cumulative effect of change in accounting principle, net, of $16 million, and an adjustment was recorded in the fourth quarter ended December 31, 2005 related to the interpretation. The adjustment will increase the asset retirement obligation by approximately $28 million.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections—A Replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 requires retrospective application to prior periods’ financial statements for changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 also requires that retrospective application of a change in accounting principle be limited to the direct effects of the change. We were required to adopt SFAS No. 154 as of January 1, 2006. The adoption of this standard will not have a material impact on our combined financial statements.

Quantitative and Qualitative Disclosures about Market Risk

The risk inherent in our market risk sensitive instruments and positions is the potential loss arising from adverse changes in those factors. We are susceptible to market risks related to changes in interest rates and do not purchase or hold any derivative financial instruments for trading purposes.

We are subject to interest rate risk primarily associated with our borrowings. We selectively enter into swap and other agreements to manage our exposure to interest rate changes on our debt.

All our outstanding debt at December 31, 2005 is fixed-rate debt. While changes in interest rates impact the fair value of this debt, there is no impact on earnings and cash flows because we intend to hold these obligations to maturity unless market conditions are favorable.

Because we carried no variable rate debt during 2005, an interest rate sensitivity analysis is not necessary. Accordingly, a 1% change in interest rates would not impact the Combined Statements of Operations and Combined Statements of Cash Flows at December 31, 2005.

We also perform a sensitivity analysis on the fair market value of our outstanding debt. A 10% decrease in market interest rates would cause a $37 million increase in fair market value of our outstanding debt to $1.3 billion as of December 31, 2005.
BUSINESS

Overview

We offer regulated local communications services as an ILEC to roughly 5% of U.S. households, with approximately 7.26 million consumer and business access lines, as of March 31, 2006. Following the spin-off, we will provide a suite of communications services, consisting of local and long distance voice and data services, including high-speed Internet access. We also expect to provide access to our local network and other wholesale communications services for other carriers, communications equipment for business markets, and other communications-related services. Following the spin-off, we expect to provide CDMA-based wireless voice and data services in most of our local service territories to consumers and small business customers through a non-exclusive wholesale arrangement involving an MVNO relationship with Sprint Nextel. Small business customers for purposes of the MVNO relationship are defined as businesses with less than 80 lines of wireless services. We also expect to offer certain wireline voice and data, wireless and video services through sales agency and other wholesale agreements.

Following the spin-off, our assets and business will consist largely of those that Sprint Nextel attributes to its incumbent local communications operations and that are reported as its Local segment in its financial statements. Following the distribution, we will be an independent, publicly traded company and we expect to be included in the Fortune 500 list based on our historic revenues and those of other companies included in the most recent version of that list.

We will continue to serve our local service territories, which are located in 18 states. We have a significant presence in Florida, North Carolina, Nevada and Ohio (these four states represent nearly two-thirds of all of our access lines). The remaining states (in order of number of access lines) are: Virginia, Pennsylvania, Texas, Indiana, Missouri, Tennessee, New Jersey, Minnesota, Kansas, South Carolina, Washington, Oregon, Nebraska and Wyoming. We are the “carrier of last resort” and, therefore, are entitled to receive funding under universal service programs in our local service territories.

The following map shows the location of our service territories:
We were incorporated in Delaware in 2005; however, our roots trace back to 1899 and the Brown Telephone Company in Abilene, Kansas. Over that period, we have invested substantial resources to improve and expand our network infrastructure to provide quality communications services and customer care. This capital investment and an effective sales effort have historically allowed us to achieve reasonably stable operating results, revenue and cash flow.

Following the spin-off, as part of our overall business strategy, and consistent with the limitations under the tax sharing agreement, we expect to regularly evaluate business opportunities. These may include investments in current or new business lines and both acquisitions that complement our business and divestitures. At any time we may be discussing or negotiating a transaction that, if consummated, could have a material effect on our business, financial condition, liquidity or results of operations. Our board of directors will evaluate our historic strategies and may decide to adopt new strategies in the future.

Following the spin-off, we expect to have total indebtedness of approximately $7.25 billion. A portion of this debt is currently outstanding and the remainder, approximately $6.6 billion, will be incurred and payable to Sprint Nextel and one or more third parties in connection with the spin-off. We intend to incur the new indebtedness and use the cash proceeds in partial consideration for, and as a condition to, the transfer of the assets to us by Sprint Nextel in the spin-off.

Our Strengths

We believe our strengths will enable us to continue to generate cash flow and to grow new streams of revenue by diversifying our offerings, such as high-speed Internet services, while also allowing us to focus our efforts on minimizing the loss of access lines in our traditional local wireline business. Our principal strengths include:

### Longstanding customer relationships

As the incumbent provider of communications services in our local service territories, we have developed longstanding customer relationships. Based on our estimates, we provide communications services to approximately 85% of the total potential customers in our local service territories. We manage our service offerings at the local level to serve the needs of each community effectively and efficiently. As a provider of traditional and new wireline services in our local service territories, our infrastructure is readily available to meet our customers’ evolving needs and we strive to be their preferred choice as they seek additional services. To become the preferred choice of our customers and prospective customers, we continually aim to improve the quality of the customer experience for all products, at all touch points, in all our markets. The separation of our company from Sprint Nextel will allow our local customers to be served by a company whose primary strategic focus is providing services in the local service territories where those customers are located. We strive to continuously improve our current products and service offerings and we also plan to expand our product portfolio, both by internal development and external partnering efforts, in order to meet demand for broader communications services. Our dedicated sales and customer service representatives have local market knowledge and we offer bundled services that are designed to meet our customers’ needs, while also simplifying their selection and use of our services.

### Pre-existing network infrastructure

As the incumbent provider of communications services in our local service territories, we have a network infrastructure already in place to serve our customers’ current needs and that can also serve as the foundation for offering new services to meet our customers’ evolving needs. One example is our offering of high-speed Internet services, which, as of December 31, 2005, are available to approximately 74% of our local communications customers. By having a pre-existing wireline network with significant traffic that is capable of high-speed Internet services, we have been able to efficiently deploy these services without incurring the capital costs.
associated with creating new wireline connections to the customers’ premises. As a result, these high-speed Internet services have generated reasonably consistent cash flow.

**Ability to offer a wide array of bundled services**

We believe that following the spin-off, we will be among the few communications service providers in many of the markets we serve that can provide a suite of services to both consumers and business customers that includes wireline voice services, high-speed data, consumer video entertainment services, and communications equipment for business customers. We plan to expand our service offerings by providing CDMA-based wireless voice and data services to our consumers and business customers in our local service territories through our MVNO and sales agency relationships with Sprint Nextel. We also expect to offer certain wireline voice and data, wireless, and video services through sales agency and other wholesale agreements. We seek to maximize profitable communications services revenue per customer through the convenience and cost savings of using a single provider for a broad suite of services. By offering a bundled package of products and services, we have improved our long distance and high-speed Internet services penetration, resulting in increased revenue and lower customer churn, which have helped to offset revenue decreases driven by continuing declines in access lines and product substitution. Since we introduced our high-speed Internet access service in 1999, we have successfully grown our high-speed Internet base to approximately 693,000 lines at December 31, 2005, which represents approximately 9.4% penetration of our access lines. Going forward, we expect to go beyond merely bundling services by offering truly integrated or converged services and we believe that, combined with the modernization of our networks (such as by circuit to packet migration) and support systems, this will allow us to be more competitive and thereby achieve a greater market share.

**Favorable demographics**

The annual growth in number of households in our local service territories has averaged approximately 1.8% over the three years ended December 31, 2005, compared to the national average over that period of approximately 1.3%. Our local service territories cover all or part of six of the 20 fastest growing MSAs based on the 2000 census. Approximately 29% of our access lines as of December 31, 2005 were in those MSAs.

**Service and product expertise**

We believe that our strong heritage provides a solid foundation for the continued development and delivery of cost-effective products and services. For over 100 years, our business has focused on providing high quality communications products and services to meet the evolving needs of our customers. We intend to build on the core strengths of our business to fulfill our mission of providing high quality, cost-effective products and services and innovations that address our customers’ communications needs. We believe that our experienced employee base will help us to fulfill this mission. In particular, many of our dedicated sales and customer service representatives have local market knowledge.

**Experienced management team**

We have a senior management team with experience managing the expansion of communications companies, including experience at Sprint. Our management team has, to a large extent, been operating in its current composition since August 2005.
**Business Strategy**

Our strategy is to maximize profitable communications services revenue per customer by selling integrated and bundled products and services and meeting the needs of our consumers and business and wholesale customers within our local service territories. Four key goals will support this strategy:

**Provide Useful Products and Solutions to Attract and Retain Customers:**
- actively market integrated service offerings featuring local and long distance voice, high-speed data, video and wireless services and customer premises equipment, or CPE, that are designed to serve the customers’ communications needs;
- expand high-speed Internet coverage, deliver faster Internet services and enhance the product to increase market penetration and customer retention;
- offer video services through our direct broadcast satellite, or DBS, arrangement;
- deliver attractive wireless voice and data services in a large portion of our markets, through agency and MVNO arrangements with Sprint Nextel and possibly others;
- deliver products and services that meet targeted customer needs and provide product and service simplification; and
- over time convert our backbone and distribution networks to an IP structure, including VoIP, to expand our ability to provide value enhanced services.

**Improve Customer Experience and Perception of Service and Product Offerings:**
- provide our customers a simple, accurate, easy-to-understand bill;
- maintain quality and reliability of our wireline services;
- be the preferred “hometown” communications company capitalizing on and continuing our long-term customer relationships and involvement in the communities we serve;
- expand convenient and innovative distribution channels; for example, by increasing the number of retail stores to increase our local presence;
- offer services at competitive prices; and
- serve our customers with knowledgeable, motivated, enabled and accountable sales and customer support associates, and effectively resolve customer issues in a single service call.

**Manage Costs:**
- implement process improvements to increase operational efficiency;
- establish network investment priorities consistent with our business strategies, including to support enhanced service offerings:
  - invest in high-speed network facilities;
  - minimize investment in legacy copper network; and
  - deploy packet switching where it is economically justified;
- improve our systems to provide support to e-commerce sales and improve the effectiveness of our customer support operations; and
- simplify legacy IT support systems.


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**Maintain a Customer-Focused Culture that Encourages High Performance and Employee Satisfaction:**

- maintain our strong commitment of service to the local communities in which we operate;
- be innovative and competitive in our approach to serving our customers;
- continue to deliver an exceptional customer experience;
- improve management focus, quality and communication;
- maintain a culture of success by aligning management and employee incentives to performance;
- be a great place to work; and
- deploy sales compensation plans that support our objectives and are easy to administer and understand.

**Our New Brand**

On February 1, 2006 we announced our new brand name, EMBARQ, and unveiled our new logo. Embarq Corporation is our holding company name, and EMBARQ will be the brand of our local communications operations, products and services. In addition, we expect to associate our EMBARQ brand with products that we resell to our customers, including long distance and wireless services. We expect that we will use the EMBARQ brand with the sale of our long distance services as early as late April 2006 and in conjunction with the rest of our services on or shortly after the distribution date. We plan to invest significant resources to develop and build awareness of our new brand in our local service territories. We believe that having strong brand recognition, built on a consistent message, will help us grow as an independent company.

**Our Services and Product Offerings**

We currently operate our business in two segments: Local and Product Distribution.

Through our Local segment, we offer three general categories of products and services: voice, data and other. We currently provide a wide range of products and services through these categories, including the following:

**Voice:**

- local calling services;
- access services to long distance carriers, wireless carriers and CLECs; and
- wholesale services.

**Data:**

- high-speed Internet access services; and
- special access services.

**Other:**

- long distance voice and data services;
- wireless services;
- video services and pay per view;
• communications equipment; and
• engineering and customer support services.

Through our Product Distribution segment, we provide:
• wholesale product distribution;
• logistics; and
• configuration services.

After the spin-off, in addition to or in place of certain current offerings (for example, we will no longer sell wireless services to the consumer market as a Sprint Nextel agent), we expect to provide our own branded wireless voice and data services to consumers and small business customers in most of our local service territories through wholesale arrangements, such as the MVNO relationship with Sprint Nextel. However, we expect to offer Sprint Nextel-branded wireless services to certain medium and large business customers through a sales agency agreement with Sprint Nextel. We also expect to offer our own branded long distance voice and data services, primarily through a wholesale relationship with Sprint Nextel. We plan to provide certain other Sprint Nextel-branded wireline voice and data services to large business customers, including data networks that extend out of our local service territories, through a sales agency arrangement with Sprint Nextel. See “Agreements with Sprint Nextel—Commercial Service Agreements.”

The following chart summarizes the components of our revenue sources during each of the last three years in the period ended December 31, 2005:

<table>
<thead>
<tr>
<th>Revenue Source</th>
<th>Years Ended December 31,</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2005</td>
<td>2004</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(millions)</td>
<td></td>
</tr>
<tr>
<td>Local segment:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Voice</td>
<td>$4,003</td>
<td>$4,157</td>
<td>$4,268</td>
</tr>
<tr>
<td>Data</td>
<td>983</td>
<td>833</td>
<td>730</td>
</tr>
<tr>
<td>Other</td>
<td>705</td>
<td>749</td>
<td>806</td>
</tr>
<tr>
<td>Product Distribution segment:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Third Party</td>
<td>509</td>
<td>341</td>
<td>290</td>
</tr>
<tr>
<td>Related Party</td>
<td>54</td>
<td>59</td>
<td>65</td>
</tr>
</tbody>
</table>

See “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

Local segment

Voice

Local Services. We provide local calling services to consumers and business customers within our local service territories, generally for a fixed monthly charge. In the vast majority of our local service territories, the amount that we can charge a customer for local calling services is governed by state and/or federal regulatory authorities. We also provide a number of enhanced calling features, such as call forwarding, caller identification, voicemail and call waiting, for which we generally charge an additional monthly fee. We also generate revenue from non-recurring services, such as service activation and reactivation. As of March 31, 2006, we had approximately 5.0 million consumer and 2.1 million business access lines. In the consumer category, as of March 31, 2006, approximately 73% of our customers purchased at least one additional service from our portfolio of services that also included Sprint Nextel long distance and wireless services, and approximately 43% of our customers purchased two or more of those additional services.
Access Services. Long distance carriers, wireless carriers and CLECs purchase various forms of switched access services thereby enabling connectivity with their networks and facilitating our local customers’ ability to make or receive long distance calls. Access charges for interstate and international calls are regulated by the FCC, while access charges for intrastate calls are regulated by the state public utility commissions, or PUCs.

Wholesale Services. In addition to access services, FCC regulations require us to offer certain of our network facilities to CLECs on an unbundled basis (i.e., UNEs) and to allow them to collocate some of their equipment in our central offices. The FCC sets general guidelines for pricing of UNEs and collocation and state PUCs set the actual prices charged. As of March 31, 2006, we had approximately 219,000 wholesale access lines, including UNE lines and resold access lines.

Data

High-speed Internet Access Services. As of March 31, 2006, we provided high-speed Internet access services for a monthly fee over approximately 777,000 lines in service. Our primary high-speed Internet offering features a download and upload speed of up to 1.5 Mbps, but we also offer download speeds ranging from 256 Kbps to 5.0 Mbps. Our high-speed Internet services are offered primarily using a DSL service delivery platform.

Special Access Services. In addition, large businesses, long distance carriers, wireless carriers and CLECs purchase “special access” facilities, which consist of dedicated circuits used to connect their business sites or their networks to ours, to connect their networks directly to their customers’ locations, or, in the case of wireless carriers, to connect their cell sites with their mobile switching centers. Although the traffic through special access facilities may include voice as well as data, we have historically reported revenues associated with special access as data revenue.

Other

Long Distance Voice and Data Services. Currently, we offer long distance voice and data services through a sales agency arrangement with Sprint Nextel. Following the spin-off, we plan to offer to our consumer customers long distance voice calling services either based on usage or pursuant to flat-rate calling plans. These services include traditional switched long distance, toll free calling, international, calling card and operator services. We also expect to offer long distance voice and data services to business customers. Voice services will include traditional switched and dedicated long distance, toll free calling, international, calling card and operator services. In connection with the spin-off, we expect that Sprint Nextel’s switched long distance consumer customers, and certain of its switched long distance business customers, that reside or are headquartered in our local service territories will, subject to federal and state regulatory approvals, be transferred by Sprint Nextel to one of our subsidiaries. Certain IP data customers may also be transferred if all of their locations are within our local service territories. Data services offered to business customers will include dedicated IP circuits, frame relay over IP and multi-protocol label switching, or MPLS, over IP. We anticipate that the primary underlying network provider for the long distance services we provide will continue to be Sprint Nextel after the distribution. We plan to purchase long distance services from Sprint Nextel and other providers at wholesale and then sell them to our customers under our new brand. Following the distribution, revenues associated with these services will be reported in the voice category. We also expect to sell some long distance voice and data services to large business customers as an agent of Sprint Nextel. See “Agreements with Sprint Nextel—Commercial Service Agreements.” As of March 31, 2006, of our access lines on which a primary interexchange, or long distance carrier, is selected, we had an approximately 63% share of consumer lines and approximately 51% of business lines for which long distance services are provided through our offering of Sprint Nextel long distance services.

Wireless. We currently offer wireless services through a sales agency relationship with Sprint Nextel. Following the distribution, our consumer and small business wireless services are expected to be sold primarily as our own branded wireless services in most of our local service territories through wholesale arrangements with
third parties, including the MVNO relationship with Sprint Nextel. We are entering into the MVNO relationship with Sprint Nextel to facilitate our ability to develop our own branded CDMA-based wireless services and product bundles in order to leverage our wireline assets. We expect to begin providing these services as early as June 2006. The MVNO relationship with Sprint Nextel is a seven year agreement, with price points driven by volume, type of service (i.e., voice or data) and customization. Through the MVNO relationship with Sprint Nextel, we will have access to a nationwide network that will mirror Sprint Nextel’s CDMA coverage in our local service territories. Currently, Sprint Nextel’s wireless network covers approximately 80% of our local service territories. We also will be able to take advantage of Sprint Nextel’s investments in its core network infrastructure. For example, as Sprint Nextel deploys its own CDMA-based high speed digital data network, as part of its core network services, we expect to be able to offer a similar service. We also expect to enter into agreements with other third party vendors to provide some or all of the billing, customer care and handset distribution and logistics needed to support our wireless customers.

Our wireless strategy is to provide a unified communications solution by including wireless voice and data services as part of larger communications services bundles offered to customers in our local service territories. Although we expect to offer stand-alone wireless services, our market emphasis will be on the creation and sale of product and services bundles that have historically improved customer retention. See “Agreements with Sprint Nextel—Commercial Service Agreements.”

Video. We currently sell video services and pay per view through a sales agency relationship with Echostar. As of March 31, 2006, approximately 112,000 of our customers purchased video services from us under this arrangement. We generally sell video services as part of a bundled products and services offering, with charges for all products and services appearing on a single bill provided by us to our customer. Over time, our video service offering may include an approach that utilizes owned facilities in certain markets and sales agency arrangements involving satellite-based services. While there are many relevant considerations, population density would be a critical factor in deciding which technologies to pursue and in which markets.

Equipment and Professional Services. We sell a range of CPE, which is communications equipment that resides at a business customer’s location for the management of voice and data networks and applications. We provide CPE to our customers through sales, engineering, and distribution relationships with a small number of primary vendors and logistics support from our Product Distribution segment. We also provide inside wiring services at consumer and business customer locations to install, maintain or upgrade equipment. We also offer engineering and customer support services to our customers, remote management and monitoring of CPE, remote security services to protect customer information and networks, and maintenance of equipment under contract.

Product Distribution segment

Through our Product Distribution segment, we procure, configure and distribute equipment, materials and supplies to the communications and cable industries. The products that we offer include outside plant, business communication systems, telephones and accessories and network access equipment from leading manufacturers across multiple markets. With approximately 1,000 employees, including experts in logistics, engineering, integration and deployment, and communications equipment, Product Distribution offers supply chain solutions that are recognized for their innovation, effectiveness and efficiency. Product Distribution operates six distribution centers throughout the U.S. The group currently stocks more than 20,000 items from more than 1,300 manufacturers. Product Distribution will serve in a supply chain management function within our company, which will help to create scale and reduce costs. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”
Sales and Marketing

We plan to market and sell our products and services through four main marketing groups: Consumer Markets, Business Markets, Wholesale Markets and Product Distribution, each of which is described below. Our sales and marketing functions, including product development, product management, research, advertising and promotions, will be managed individually by each marketing group.

To foster long-term relationships with our consumers and business customers, we have undertaken many initiatives to provide quality customer service. We operate approximately 20 retail and two wholesale call centers, located mainly in our local service territories, staffed with customer service representatives who are knowledgeable about the local markets we serve. In addition, we have automated many of our customer service functions, including Internet e-commerce systems, so that our customers can receive answers to many frequently asked questions regarding their communications services without speaking to a customer service representative. We continue to consolidate our service plans and simplify our invoices to better meet our customers’ needs.

We locally manage our service offerings in an effort to serve the needs of each customer effectively and efficiently. We are committed to a high standard of service and have sales representatives with market knowledge of the local service territories in which we operate. Based on our understanding of our customers’ needs, we offer bundled services that are designed to simplify the customer’s selection and ability to use our services. Offering bundled services allows us to capitalize on our network infrastructure by offering a suite of communications services in local voice, high-speed Internet access, and long distance services, as well as wireless and video. We believe that offering bundled services improves customer retention and gives us the opportunity to offset declining access lines due to wireless substitution and competition from cable operators and CLECs.

Consumer Markets

Consumer Markets provides a portfolio of bundled wireline and video services to consumers in our local service territories. Consumer Markets historically has also sold Sprint Nextel-branded wireless services and long distance services under a sales agency agreement with Sprint Nextel. Following the spin-off, Consumer Markets will continue to focus on selling bundled wireline services and video services, but will also sell wireless services and long distance services under our new brand. The group offers products and services through a variety of channels, including call centers, the Internet, retail stores and third-party channels.

Consumer Markets has had success in the sale of high-speed Internet service with a growth rate of over 41% in 2005. While we anticipate continued growth, we expect the percentage growth rate to decline. At December 31, 2005 and March 31, 2006, we had over 552,000 and 625,000, respectively, consumer high-speed Internet lines in service.

Our consumer retail marketing approach emphasizes customer-oriented sales, marketing and service with a local presence. We market our retail products and services primarily through our customer service representatives, direct sales representatives, local retail stores and telemarketing. We support our distribution with direct mail, bill inserts, newspaper advertising, website promotions, public relations activities and sponsorship of community events. In our local service territories, we operate retail stores that allow our customers the opportunity to pay their bills directly or meet personally with our customer service and sales representatives to purchase additional services and, in some locations, customer premises equipment. Our customer service and sales representatives promote sales of services to meet the unique needs of our customers. Sales channels are being expanded to increase the visibility of our products and services in third-party retailers and on websites that are co-branded with our business partners. At December 31, 2005, we had 29 retail stores, and we expect to have between 55 to 60 stores by the end of 2006.

The number of households in our local service territories, which include portions of the Southeastern U.S. and Las Vegas, is growing faster than the national average. In fact, our local service territories cover all or part of
six of the top 20 fastest growing MSAs, based on the 2000 census. These include Las Vegas (#1), Naples (#2), Raleigh-Durham (#12), Orlando (#16), Ocala (#18) and Fort Myers (#20). In an effort to maximize our growth, we are expanding our approach to consumer marketing and sales in these areas. Our broadened strategy includes new product offerings that we expect will appeal to households in which wireless phones are becoming the primary means of communication. We are also actively working with property developers to provide the right infrastructure and services to support technology needs of new home owners.

Consumer Markets’ strategy includes improving market penetration and maximizing profitable communications services revenue per household through cross-selling, up-selling, and selling a full bundle of services to meet customers’ communications needs. Consumer Markets’ strategy also includes expansion of the entertainment components of its portfolio and integrating video with wireline services to deliver competitively priced integrated product bundles for our customers.

**Business Markets**

Business Markets provides a broad portfolio of local, wireless, long distance and equipment products and services designed to meet the needs of business customers. Key products include high-speed data, wireless and long distance voice services as well as traditional local wireline and CPE. The group offers products and services through a variety of channels, including call centers, the Internet, retail stores, direct sales and third-party channels. Following the spin-off, we expect to sell our own branded wireline and wireless services to small business customers. We also expect to use the sales agency agreement with Sprint Nextel to sell Sprint Nextel-branded wireline and wireless services to medium and large business customers. However, wireless customer relationships that exist at the time of the spin-off will remain with Sprint Nextel after the spin-off. See “Agreements with Sprint Nextel—Commercial Service Agreements.”

Our business customer retail marketing approach focuses on end-to-end customer communications solutions from small businesses to large enterprise customers. We market our retail products and services to business customers through several channels, including direct sales forces located in each of the areas we serve, call center sales and service representatives, telemarketing programs, third party agents and local retail stores. Our direct sales force calls on prospective and existing business customers to provide a reliable and complete communications solution that best fits the needs of our customers based on our communications knowledge and the information we gain about the customers’ needs. Our network engineers design services, products and applications that help our customers operate their businesses. Our technicians survey customer premises to assess building entry, power and space requirements for communications equipment and coordinate delivery, installation and testing of equipment. We utilize many advertising and promotional programs, including direct mail, bill inserts, media advertising, newspaper advertising, website promotions, public relations activities and sponsorship of community events. In 2006, we plan to continue expanding our selling channels by growing our business presence in our retail stores, utilizing third party retailers and leveraging value added resellers.

Business Markets’ strategy includes a commitment to deliver communications solutions that meet existing and future business customer needs through bundles of services, integrated service offerings and the development of innovative products and services.

**Wholesale Markets**

Wholesale Markets offers a variety of network-based products and database services to local, long distance and wireless carriers. Carriers utilize these wholesale products as part of their infrastructure and support systems in providing end-user retail services. Key products for this group include switched and special access, UNEs, collocation, database, directory assistance, operator services, high-speed data and access to network signaling systems. With the growth in wireless voice and data services, wireless carriers operating within our local service territories are increasingly purchasing wholesale services to link their towers and to interconnect with our wireline networks. As of December 31, 2005, Wholesale Markets also provided public access services to
approximately 24,500 pay telephone units in 43 states. Further, through 22 account relationships, Wholesale Markets provides
communications services to inmates at 161 state and county correctional institutions.

Our wholesale marketing approach includes direct sales calls to our carrier customers in the interexchange long distance,
wireless, CLEC, and Internet Service Provider, or ISP, market segments. Wholesale revenues are derived primarily from switched
access for originating and terminating long distance calls, special access to provide dedicated links between customer premises and
carrier networks, intelligent network database services and interconnection services to link networks between carriers.
Approximately 80% of our wholesale revenues come from 20 carriers. Our associates work closely with these customers to develop
products and services that address their specific needs and to help ensure that we continue to be the wholesale provider of choice
within our local service areas. In addition, our dedicated account managers and supporting sales engineers consult with these
customers on network design and application needs.

Wholesale customers have access to the majority of our products and services through our wholesale website and through
tariffs that are filed with state and federal regulatory agencies. We are working to improve our wholesale website both to enhance
the customer experience and to reduce calls to wholesale service centers.

Wholesale Markets’ strategy is focused on providing superior network service quality and products tailored specifically to its
customers’ business needs.

Product Distribution

Product Distribution’s sales and marketing approach emphasizes providing cost competitive communications products
through, what we believe to be, a world class logistics organization. We service our network service provider and reseller customer
base through a direct sales organization, centralized call center operations and e-commerce activities. We support these channels
with direct mail, bill inserts, trade advertising, website promotions, public relations activities and participation in key industry trade
shows. Our sales and service organization helps customers design advanced supply chain solutions by providing engineering and
installation services to help improve the operational efficiency of their businesses.

Product Distribution’s strategy is to achieve economies of scale in purchasing and to provide customers with a reliable
infrastructure to meet a wide variety of supply chain needs through its logistics network, which is comprised of “best-in-class”
information technology systems and strategically located distribution centers.

Network Architecture and Customer Support

Our network consists of host and remote central office digital switches and digital loop carriers interconnected with copper,
microwave and fiber facilities. Our equipment typically operates on the most current software in generally available release. The
outside plant infrastructure connecting the customer with the core network also consists of a mix of copper and fiber optic cables.
As of December 31, 2005, we maintained over 330,000 miles of copper plant. Our network also includes approximately 37,000 miles of
local and long-haul fiber optic cables typically powered with synchronous optical network, or SONET, terminals, which are the
primary transport technology between our 318 host and 1,605 remote central offices and interconnection points with other ILECs.
We have a robust SONET-based transport architecture utilizing over 3,000 survivable rings. This architecture increases reliability to
both consumers and business customers. Our network also contains 12 Signaling System 7, or SS7, pairs, or 24 transfer points, to
provide call control and signaling. We also have approximately 900,000 access lines converted to packet switching infrastructure
and we were the first ILEC to launch a conversion to packet switching. In addition, we have deployed approximately 33% of the call
servers needed to support a soft switch network architecture. This packet infrastructure positions us for new services and products.
In our markets, high-speed Internet-enabled integrated access technologies are being deployed to provide significant broadband capacity to our customers. We continue to modify the network to offer high-speed Internet service to more customers; as of December 31, 2005, approximately 74% of our access lines were capable of providing high-speed Internet service to our customers. We continue to evaluate new high-speed Internet technologies, fixed wireless and other Internet high-speed enhancements that could expand the coverage and data speeds of our high-speed Internet offerings.

Rapid and significant changes in technology are expected in the communications industry. Our future success will depend, in part, on our ability to anticipate and adapt to technological changes. We believe that our network architecture and management expertise will enable us to respond efficiently to these technological changes.

In addition to the equipment noted above, our integrated communications network includes asynchronous transport mode, or ATM, switches, IP routers, frame relay switches, Ethernet switches/routers and multi-service switches capable of handling voice, data and dedicated circuits. We currently own or lease all of our network facilities and have not booked any revenues from swaps of indefeasible rights to use.

We support our network with a customer support team of approximately 6,000 technicians who install network components and CPE and maintain and repair the network. Our technicians are highly skilled professionals trained to handle a wide range of communications elements. We have network operations centers to provide surveillance and remote maintenance of all communications products and services.

History and Development

Our company has over 100 years of experience in providing local communications services to our customers. Our earliest predecessor company, Brown Telephone Company, was founded in 1899 in Abilene, Kansas. Over the next six decades, the company grew dramatically through a series of acquisitions, and by 1976 the diversified company known as United Telecommunications had approximately $1 billion in revenues and 3.5 million local access lines. By the early 1990s, United Telecommunications had more than 4.0 million access lines and was providing advanced consumer products, such as caller identification and call screening, to its customers. In 1992, United Telecommunications changed its name to Sprint Corporation and began selling our products and services under the Sprint brand. In 1993, Sprint’s merger with Centel Corporation increased the number of Sprint’s access lines by 1.7 million.

In 1998, Sprint reorganized its local communications business from regional operations to a single national organization focused on three key customer sets: businesses, consumers and carriers. A year later, Sprint began offering high-speed Internet services to its customers. In 2003, Sprint’s local business became the first major communications business to begin the conversion from a circuit-switched local communications network to a simplified, next-generation packet network. In December 2004, Sprint announced plans to merge with Nextel and its intention to subsequently spin-off the local communications business into a stand-alone company, thereby creating Embarq. The merger with Nextel was completed in August 2005.

Competition

There is widespread competition among communications services providers. The traditional dividing lines between local, long-distance, wireless, video and Internet services are increasingly becoming blurred. Through mergers, joint ventures and various service expansion strategies, major providers are striving to provide integrated services in many of the markets we serve. This trend is also reflected in changes in the regulatory environment that have encouraged competition and the offering of integrated services. We expect competition to intensify as a result of the entrance of new competitors and the rapid development of new technologies, products and services.
Competition may adversely impact our revenues and profits in several ways, including:

- the loss of customers and market share;
- the possibility of customers shifting to less profitable services;
- forcing us to lower prices or increase capital or marketing expenses to remain competitive; and
- increasing our need to incur additional costs in order to diversify by offering new products or services.

ILECs increasingly face competition from alternate communication systems constructed by facilities-based providers, including CLECs, long-distance carriers, large customers, alternative access vendors, cities and local governments, rural over-builders and other entities. Some of these systems, which have become more prevalent as a result of the Telecommunications Act of 1996, which we refer to as the Telecom Act, and recent technological developments, are capable of originating or terminating calls without use of the ILECs’ networks or switching services. Other providers, including VoIP carriers, make use of the high-speed Internet access services that we provide to our customers and may displace the local, long-distance, calling features and switched access revenues that we formerly obtained from conventional forms of voice services. We anticipate that all these trends will continue and will lead to increased competition with our services.

Much of the local competition that arose after the passage of the Telecom Act took the form of resale of ILEC services or use of the ILECs’ UNEs, either as a total package of service capabilities (generally referred to as the unbundled network element platform or UNE-P), or in combination with facilities owned by the CLEC. We have traditionally been less subject to these forms of competition than larger ILECs serving more urban areas, and recent regulatory decisions have relieved ILECs of the obligation to make UNE-P available to competitors. See “—Legislative and Regulatory Developments.” We intend to actively monitor these developments, to observe the effect of emerging competitive trends in larger markets and to develop appropriate competitive responses. Going forward, we do not believe these forms of competition will be an increasing threat to us.

We also face increasing competition from cable operators providing high-speed Internet services, which can be used as a platform to support voice services utilizing VoIP technology. For example, in 2003, only approximately 2% of households in our local service territories had cable telephony capability. At December 31, 2005, this percentage was approximately 40%, and it is expected to reach approximately 88% by the end of 2006. As voice services using VoIP technology become more robust and widely available and as the performance and quality of these services are more widely accepted by customers, cable competitors are expected to become more formidable.

Furthermore, wireless communications services increasingly constitute a significant source of competition for local communications services, especially as wireless carriers expand and improve their network coverage and continue to lower their prices. As a result, some customers have chosen to completely forego use of traditional wireline phone service and instead rely solely on wireless services. Our access line losses are escalating as an increasing number of households become wireless only. We anticipate that the trend toward using wireless services will continue, particularly if wireless service rates continue to decline and the quality of wireless services improves. Technological developments in cellular telephone, personal communications services, digital microwave, satellite, broadband radio services, broadband over powerline, local multipoint distribution services, meshed WiFi and other wired and wireless technologies permit the further development of alternatives to traditional wireline services. Changes in technology generally result in new entrants into the communications services marketplace. See “Risk Factors—Risk Factors Relating to our Business—Due to competitive, technological and regulatory changes, we cannot assure you that our core business will grow, and it could decline, which could have an adverse effect on our business and future prospects.”

Many of our current and potential competitors have market presence, engineering, technical and marketing capabilities and financial, personnel and other resources greater than ours. In addition, some of our competitors
can conduct operations or raise capital at a lower cost than we can and are subject to less regulation, taxes or fees. Consequently, some competitors may be able to charge lower prices for their products and services, develop and expand their communications and network infrastructures more quickly, adapt more swiftly to new or emerging technologies and changes in customer requirements, and devote greater resources to the marketing and sale of their products and services than we can.

Despite the various challenges facing our business, our numerous strengths, such as our established customer relationships, existing network architecture, extensive product and service expertise and wide array of bundled offerings, are helping us in our efforts to reduce access line losses and grow our customer base. We intend to continue challenging the competition with:

- innovative bundled offerings that not only respond to but anticipate our customers’ changing needs;
- new product offerings, such as continued roll-out of high-speed Internet access;
- effective customer care and simplified billing; and
- attractive and simplified pricing.

### Legislative and Regulatory Developments

The communications industry has been and remains the subject of legislative and regulatory oversight at both the federal and state levels. The Telecom Act was the first comprehensive update of the Communications Act of 1934. Among other things, the Telecom Act provided a framework for local competition, but required the adoption of implementing rules by the FCC and the states. These rules have been the subject of numerous court appeals, as well as lobbying efforts before Congress. In virtually every session of Congress since the adoption of the Telecom Act, legislation has been proposed to amend it, and there is growing interest in Congress in undertaking another update of the Communications Act of 1934. In addition, members of Congress use Congressional hearings and letters to emphasize points to regulators. Congressional participation in the development of regulatory policy and enforcement makes the regulatory process less predictable and potentially adverse to our interests. Various state legislatures also engage in regulatory policy matters that affect our business.

As an ILEC we are subject to pervasive regulation by both state and federal regulatory bodies. While the amount of regulation is diminishing, we remain subject to more regulation over communications services than many of our competitors and competition is increasing at a faster rate than regulation is decreasing. 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 communications industry. Some legislation and regulations are currently the subject of judicial proceedings, legislative hearings and administrative proceedings that could change the manner in which our industry operates. We cannot predict the outcome of any of these matters or their potential impact on our business. Regulation in the communications industry is subject to rapid change and any change may have an adverse effect on us in the future. The following discussion describes some of the major communications-related regulations that affect us, but numerous other substantive areas of regulation not discussed here may also influence our business.

### State Communications Regulation

The major areas of ILEC regulation and the environment of regulatory change we face at the state level include:

**Carrier of last resort.** As an ILEC, in our local service territories we have an ongoing requirement to provide service to all those who request service and are willing to pay tariff rates. In a competitive environment this constitutes a competitive disadvantage because the competitors can choose not to provide service to customers who are credit risks or whom it would be uneconomic to serve. Relaxation of this requirement is
provided in some of our states where we are relieved of providing service to developments served by a CLEC or cable operator. Additionally, relative to customers who are especially expensive to serve, we are seeking authority to deploy service using alternative, less costly technologies, such as fixed wireless. In addition, our costs are partially offset by payments from the universal service programs. See “—Universal Service Programs.”

**Rate regulation.** Traditionally, ILEC local service prices and company earnings were regulated based on the rate of return. We are subject to this method of regulation in four of the states in which we operate: Washington, Oregon, New Jersey and Wyoming. In the remaining states, we have entered into alternative regulation, or “price cap” plans, that typically limits our ability to increase rates for local services by a predetermined formula, but relieves us from the requirement to meet certain earnings tests. Additionally, in most of the states in which we operate, we have growing flexibility to set prices for non-basic services, such as caller identification, and the price for bundled services that include basic local service. In nine of the states in which we operate, we are able to price bundles of services on an exchange-specific basis, instead of state-wide pricing, in response to competition.

**Service quality regulation.** Most of the states in which we operate impose exacting service requirements, which dictate the achievement of certain standards, including call center answer time and intervals for new service installation and service restoration when there are outages. We are making some progress in gaining relief from costly, inflexible, traditional standards, but many commissions have been slow to permit ILECs to adopt self-enforced, market-driven service standards despite the acceleration of competition.

**Federal Communications Regulation**

At the federal level, as an ILEC, we are subject to the FCC’s most extensive communications regulation. Federal regulation not only covers rates and service terms, but also the terms on which ILECs provide connections and network elements to potential competitors—the CLECs. Long distance providers are subject to less regulation, but still must comply with various statutory requirements and regulations. Commercial mobile radio service, or CMRS, providers are not regulated from a retail pricing standpoint, but are subject to various licensing and technical requirements imposed by the FCC, including provisions related to the acquisition, assignment or transfer of radio licenses, and mandates, such as enhanced 911, or E-911, and wireless local number portability.

**Competitive Local Service**

The Telecom Act was designed to promote competition in all aspects of communications. It eliminated legal and regulatory barriers to entry into local and long distance communications markets. It also required ILECs to allow local resale at wholesale rates, negotiate interconnection agreements, provide nondiscriminatory access to UNEs and allow collocation of interconnection equipment by competitors. The rules implementing the Telecom Act remain subject to legal challenges.

On February 5, 2005, the FCC issued an order, which became effective on March 11, 2005, revising rules on UNEs in response to a March 2004 decision of the D.C. Circuit Court of Appeals vacating significant portions of the FCC’s earlier UNE rules. The order terminates the ILECs’ obligation to offer unbundled local switching and UNE-P after a one-year transition period, during which there will be some increases in the rates ILECs are permitted to charge for UNE-P, and restricts, to some extent, the availability of high-capacity loop and transport UNEs. The four largest local communications companies and an ILEC trade association have challenged this order as not fully complying with the March 2004 court decision, while CLECs have filed appeals claiming that the order improperly restricts the availability of UNEs. We benefit from the UNE-P ruling, although our competitors have not made extensive use of UNE-P in our service territories. The new restrictions on the availability of high-capacity loop and transport facilities as UNEs will not have a material effect on our competition. A court reversal of the FCC order could affect our future UNE obligations.
Separately, the FCC is considering whether it should establish performance measures for ILEC provision of UNEs and special access services and whether to revise the methodology the states must use to establish prices for UNEs.

**Universal Service Programs**

The FCC and many states have established “universal service” programs to ensure affordable, quality local communications services for all U.S. residents. Our 2005 combined federal and state universal service fund receipts were $200 million, which represents approximately 3.2% of our $6.3 billion in revenues in 2005. Of this amount, $126 million came from federal support and $74 million came from state support. We expect that our combined federal and state universal service fund receipts will be slightly less in 2006.

The federal universal service programs provide funding for services provided in high-cost areas, for reduced-rate services to low-income consumers, and for discounted communications and Internet services for schools, libraries and rural health care facilities. These programs are funded largely from assessments on communications carriers, who must make contributions that are based on an FCC-prescribed percentage (currently 10.9% of revenues from interstate and international revenues from communications services). These contributions are generally recovered from customers through surcharges. This contribution mechanism subjects us to competitive disadvantages in at least two respects. First, companies that offer competing services that they characterize as “information,” rather than “telecommunications,” services, including some providers of VoIP services, do not contribute to federal universal service funding and, therefore, are able to charge their customers less for the competing services. Second, the FCC has classified the cable modem broadband Internet access service offered by cable companies (in competition with our high-speed Internet access service) as an information service which is not subject to universal service fund contributions, while requiring ILECs to make universal service contributions on a portion of their high-speed Internet access revenues. A recent FCC order, discussed under “—High-speed Internet Access Services” below, will put high-speed Internet access service on an equal footing with cable modem service after a transition period. The FCC is considering whether to replace this revenue-based assessment in whole or in part with an assessment based on telephone numbers or connections to the public network. An assessment mechanism based on numbers or network connections could increase our contributions to federal universal service funds, but at the same time could eliminate the competitive disadvantages we face under the current system.

Of the federal universal service programs’ funding, in 2005 we received $126 million from federal universal service funds to support our service in high-cost areas. A portion of this support is based on average loop costs. Our loop costs exceed the nationwide average in many of our local service territories. The FCC has proceedings underway to reexamine contribution levels to the funds and the distribution of high-cost support and to consider expanding the fund to include support for broadband deployment. FCC decisions in those proceedings could affect the amount of high-cost support we receive in the future.

The current state universal service fund receipts, which totaled $74 million in 2005, flowed from programs in seven states: Kansas, Nebraska, Oregon, Pennsylvania, South Carolina, Texas and Wyoming. Of these states, only Texas is undergoing a review of its universal service fund program, with a report and recommendation by the Texas Public Utilities Commission due to the legislature in the fourth quarter of 2006.

**Intercarrier Compensation and Access Charges**

Intercarrier compensation includes interstate and intrastate switched access charges that we and other ILECs are entitled to receive from long distance carriers for their origination and termination of long distance calls, and reciprocal compensation that interconnected local carriers pay to each other for terminating interconnected local and wireless calls. In addition, we and other ILECs receive special access charges for providing dedicated facilities to other carriers and businesses. On average, intrastate switched access charges, which are currently...
regulated by state PUCs, are substantially higher than interstate switched access charges, which are regulated by the FCC, and in turn interstate switched access charges are substantially higher than reciprocal compensation.

In 2001, the FCC launched a proceeding to determine whether access charges, as well as reciprocal compensation for local interconnected calls, should be replaced either by a “bill-and-keep” system (under which intercarrier compensation would be eliminated and all carriers would recover their costs solely from end-user customers) or by a unified intercarrier compensation system in which the same rates would apply to all forms of intercarrier compensation, i.e., interstate and intrastate switched access and reciprocal compensation. This proceeding remains pending with the FCC and it is difficult to predict the changes that might result or their timing and impact. In the meantime, the existing disparities in the rates for different forms of intercarrier compensation, and regulatory uncertainties as to which forms of intercarrier compensation VoIP is subject (see “—VoIP” below), have led to attempts by other carriers to mislabel the nature of the calls they are sending to us for termination, with a resulting diminution in our switched access revenues.

In January 2005, the FCC initiated a proceeding to examine the appropriate regulatory framework for the rates charged for special access services. The FCC is considering reforms to modify or eliminate pricing flexibility policies, and additional reforms to the price cap rules affecting special access pricing. The outcome of the FCC’s proceeding is uncertain, but it could result in significant changes to the way in which we receive compensation from other carriers and our end users for special access services. At this time, we cannot estimate whether the FCC will reform the current special access rules or, if so, whether and to what extent any changes will affect our special access revenues.

The higher, above cost, intrastate access rates have been reduced in recent years pursuant to state regulatory commission-initiated “rate rebalancing” programs that lowered access rates while simultaneously increasing basic local rates to offset the displaced access revenues. Efforts to reduce intrastate access rates have been most significant in recent years in Florida, Missouri and Pennsylvania. Further efforts to reduce state access rates or rate rebalancing could take place as part of the intercarrier compensation system reform, impacting both state and federal rates, referenced above. However, competitive market forces may limit sustainable, significant basic local rate increases. Accordingly, there may be limited opportunity to fully “rebalance” a future intrastate access rate reduction, which targets interstate access rate levels or costs, with increases to basic local rates.

VoIP

With the growing use of VoIP, the FCC is considering the regulatory status of various forms of VoIP. The outcome of these proceedings will determine whether and how retail VoIP offerings should be regulated, as well as whether VoIP providers should pay access charges and should contribute to the federal universal service fund. In February 2004, the FCC issued an order finding that one form of VoIP, involving a specific form of computer-to-computer services for which no charge is assessed and conventional numbers are not used, is an unregulated “information service,” rather than a communications service, and preempting any attempts by state regulatory authorities to regulate this service. In April 2004, the FCC ruled that long distance offerings in which calls begin and end on the ordinary public switched telephone network, but are transmitted in part through the use of IP, are “telecommunications services,” thereby rendering the services subject to all the regulatory obligations of ordinary long-distance services, including payment of access charges and contributions to universal service funds. In November 2004, the FCC preempted states from exercising entry and related economic regulation of certain other forms of VoIP that originate through the use of broadband connections and specialized customer premises equipment. An appeal of this ruling is pending in the courts.

A June 2005 FCC order, which is also the subject of a pending appeal in the courts, directed providers of certain VoIP services to offer E-911 emergency calling capabilities to their subscribers. A September 2005 FCC order ruled that the Communications Assistance for Law Enforcement Act, or CALEA, applies to certain VoIP providers and to facilities-based high-speed Internet access service providers and set an 18-month deadline for compliance, but left the technical details of compliance to a future order. This order, too, is the subject of a