

Wireline
Industry Report

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Reassessing the Impact of Access Lines on Wireline Carriers

- ◆ In this report, we assess the overall impact of wireless substitution on the telecom sector as a whole, with a focus on the different implications for both the Regional Bell Operating Companies (RBOC) and the Incumbent Local Exchange Carriers (ILEC) respective business models.
- ◆ While rural ILECs have less impending exposure to cable competition, their access line losses have been converging with the RBOCs' year-over-year percentage line losses every quarter since mid-2002 and we believe this trend of accelerating losses is unlikely to reverse in the near-term as our models for ALLTEL, CenturyTel, Citizens, and Iowa Telecom previously reflected.
- ◆ We expect cable telephony / stand alone voice-over Internet protocol (VoIP) services, including "peer-to-peer", to command over 20% market share of residential households in the U.S. by 2010.
- ◆ More importantly, we expect wireless substitution to have around a 25% market share of households by 2010, underscored by demographic data showing over 50% of U.S. households are one and two person, which we believe represent the best wireless replacement candidates regardless of age.
- ◆ The RBOCs and RBOC/IXC combinations are successfully repositioning themselves with increased exposure to wireless and enterprise, making declines in residential voice less meaningful, in our opinion, and poising them to be much different companies over the next few years.
- ◆ Historical trends suggest access lines should not be the sole measure of wireline carriers business direction, as average revenue per line has consistently trended up as access lines decline, with positive mix-shifts, up selling, and regulatory factors keeping revenue flat to up over the same period.
- ◆ Among the RBOCs, we believe Verizon faces significantly higher levels of competition from cable with over 77% of households in Verizon's territory having cable, while BellSouth's ~24% in-territory satellite penetration is likely to reduce the number of access lines susceptible to cable competition.
- ◆ We believe the rural ILECs will need to dramatically lower xDSL prices over the near-term to reduce access line losses and increase average revenue per line, which we expect to have an overall positive impact as higher xDSL penetration could shield 18% to 30% of household line erosion for these carriers over the next five years.
- ◆ We are increasing our access line loss estimates for ALLTEL, CenturyTel, Citizens, and Iowa Telecom to reflect recent trends and to coincide with our broader top-down view of the industry.

Please read disclosure/risk information on page 23 and Analyst Certification on page 24.

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In this report, we examine the impact of access line losses on the industry as a whole, including the impact of both wireless and cable VoIP competition, which we expect to be key determinants of the future of the wireline industry. We continue to view this market as being bifurcated between the RBOCs (and soon to be RBOC/IXC combinations), and the rural ILECs. In RBOC and RBOC/IXC land, consumer voice is likely to erode to very low levels relative to today's 80%-90% penetration, and enterprise, high-end data networking, and telecom systems management are expected to become more of the core businesses. **In rural markets, we believe the ILECs have a significant near-term opportunity to grow ARPU by offering dramatic price cuts on xDSL service in order to help reverse the trend of an increasingly defecting access line bases. We believe a xDSL price point around \$20 per month in most cases would actually generate significant future revenue, while indirectly giving customers a strong incentive to retain their voice line and salvaging the Universal Subscriber Fund (USF) revenue streams associated with them.**

After noticing a trend of accelerating access line losses over the last few quarters, particularly for the rural ILECs, we have undertaken a thorough examination of access lines and expected losses in our coverage universe over the next five years. In our analysis, we have examined cable VoIP adoption potential, standalone VoIP (such as Vonage and Skype) adoption potential, wireless substitution trends (along with demographic data for the country as a whole), as well as the impact of business line and residential second line trends. These trends are then compared to total U.S. households as this metric (rather than consumer access lines themselves) offers a better picture of the potential for demographic shifts to impact the access line figures over time. After forecasting technological substitution for both wireless and VoIP, we have also taken the next logical step towards determining what these trends mean for the ILECs and RBOCs. Through our analysis, we have come to several conclusions.

First, wireless substitution is well-known as a the leading cause of access line losses currently and this factor is likely to increase over time, in our opinion, particularly when examining the large percentage of households that appear to be good candidates for cutting the cord. **We forecast wireless only households could be around 25% of total U.S. households by the end of the decade, with 25.8% of households currently classified as one-person and 32.6% of households currently classified as two-person households** according to the latest census data. We believe these one and two person households are the most appropriate candidates to go completely wireless, potentially with a free VoIP over broadband service such as Skype as a complement. It is our view that wireless only households could be more prevalent than cable VoIP customers at the end of the decade based on this data, which coincides with various studies and our research indicating younger (under age 34) customers are increasingly more likely to replace or forego signing up for a traditional landline phone. We expect this impact to be bifurcated between the RBOCs and the ILECs, with the largest market share loss expected from the RBOCs, and the potential revenue impact higher for the ILECs.

Second, we think cable and stand alone VoIP will be a close second in terms of taking share away from incumbent voice providers, with these competitors' share expected to exceed 20% of U.S. households by year end 2010. Rural ILECs may be able to escape much of this competition due to several factors including lower levels of upgraded plant competing in their territory, generally lower prices, higher interconnection costs per sub, and higher levels of customer service from the incumbent than that experienced in urban markets. The downside is that their largest markets generally do face

upgraded cable plant, which clearly has the potential for telephony competition. With the multiple system operators (MSO) increasingly becoming private entities, close to 100% voice deployment in many of their systems would not be a difficult stretch given their pending and recent releases from the scrutiny of equity investors.

Third, the RBOCs have actually been more aggressive in repositioning their wireline asset bases to capitalize on the enterprise customers they have access to, which should help stem some of the impact of consumer access line losses. Over time, we believe the RBOCs will have no choice but to continue to increase their reliance on non-voice related services as their place on the scale of lines lost is expected to be at the higher end of the national average. However, residential voice revenue is increasingly a less meaningful one in determining the overall revenue growth of the RBOCs due to their successful repositioning towards wireless, data, and enterprise related businesses.

Fourth, while rural ILECs may have less impending exposure to cable competition, their access line losses have been converging with the RBOCs' year-over-year percentage line losses every quarter since mid-2002. The rural ILECs have also been able to diligently sell incremental services to their customer bases over the past four years such as caller ID, voice mail, call waiting, long-distance, and Internet service, a fact that has consistently allowed them to keep revenue flat to up as access lines decline, in our opinion. Overall, we believe this issue deserves more attention from investors, as it implies to us that access lines, the traditional measure of the direction and success of the telecom industry, may not be the best indicator of a particular carriers overall business.

To a large extent the low-hanging fruit from additional revenue via the local line has been captured, with xDSL and potentially video being the next best opportunities for revenue growth, according to our thoughts. Also, the RBOCs clearly are losing a higher percentage of lower revenue second lines (from an inflated base of these products), as opposed to the rural carriers that are likely losing higher quality primary lines. However, the rural ILECs have been slower to capitalize on the opportunity to sell xDSL, with pricing remaining higher than in urban markets, implying additional demand to be unlocked in their territory as xDSL and cable modem services are deployed. As a result, data revenue is not currently a significant factor in offsetting the various forms of revenue that are lost when a wireline customer defects, namely the local and long distance voice, network access, and USF declines as these are all attached to access line ownership to varying degrees.

Demographics Point to Increasing Wireless Substitution

Demographic data points to continued wireless substitution going forward, with this phenomenon more likely to accelerate rather than decelerate as consumers become more confident in voice quality and reduce usage of wireline phones and as younger consumers who are more comfortable without a landline become heads of households. The most recent FCC household subscribership data pinpoints wireless substitution at around 6% of households. This is consistent with the level of line losses to date in the industry. In addition, we note 25.8% of households are one-person while two-person households, many without children, are 32.6% of the population. Families with children under 18, the most likely household to retain a wireline phone, represent around 35.5% of households.

| Category | Percent of Households | Likelihood of Ditching Landline |
|------------------------------|-----------------------|---------------------------------|
| One-Person | 25.8% | High |
| Two-Person | 32.6% | Medium to High |
| Family w/ children under 18 | 35.5% | Low |
| Married Couple – No Children | 16.1% | Low to Medium |
| 24 and Under | 34.9%* | High |
| 45 and Over | 38.1%* | Low? |

* Percent of total population currently 24 and under.

Source: U.S. Census Bureau and Raymond James estimates.

Some carriers have experienced a rising proportion of the retired population turning off their wireline phones upon returning from their annual extended sunbelt vacations (the 'snowbird' effect). This contingency has relied on a wireless phone for the winter while they are in their seasonal home and realize when they come back they have no need for a landline. While this is not a demographic, many people focus on as a wireless substitution market, we note many of these households fall into the one- to two-person demographic listed above as well as younger people more traditionally thought of in this class. The same reasoning can be inferred for one or two person households that travel significantly or simply have lifestyles that do not result in large amounts of time at home. One key factor, however, is that we believe most of these customers are also strong candidates/purchasers of broadband service and represent another argument for naked DSL, which we discuss further, below.

Cable Competition and VoIP Substitution

In order to get a sense for where cable could be in three to four years, we believe investors should look no further than Cox Communications. As of 1Q05, Cox had 22.3% penetration of basic video subscribers and 21.4% penetration of telephony ready homes passed (the company now has a significant number of standalone voice or voice and data customers). The company added over 111,000 voice subscribers in 1Q05, with the company deploying VoIP service to homes where switched voice service was not available. It is our view that Cox's penetration represents an indication of cable's likely impact on RBOC access lines over the next three to four years considering it was well ahead of the overall industry in voice deployment.

However, we note cable's long-term competitive impact may be somewhat inhibited by satellite penetration in the U.S. This statement is supported by overall satellite and cable penetration as a percentage of "U.S. TV watching households," which widely varies by market. In analyzing this data by RBOC footprint, we believe Verizon's territory is most susceptible to cable competition because overall cable penetration is significantly higher than for

the other RBOCs. Conversely, we estimate cable penetration among TV watching households is the lowest for Qwest, which generally has the most rural territory, while BellSouth has the highest satellite penetration among the top 110 markets in the U.S. separated by RBOC. In the following tables, we highlight cable and satellite penetration among TV watching households in the top 110 U.S. markets among the RBOCs.

| Cable Subscribers as a Percentage of Total TV Households (Top 110 Markets = ~88% of households) | |
|---|--------------------|
| <u>RBOC</u> | <u>Penetration</u> |
| BellSouth | 65.8% |
| Qwest | 58.6% |
| SBC | 62.0% |
| Verizon | 77.6% |

| Satellite Subscribers as a Percentage of Total TV Households (Top 110 Markets = ~88% of households) | |
|---|--------------------|
| <u>RBOC</u> | <u>Penetration</u> |
| BellSouth | 23.6% |
| Qwest | 22.8% |
| SBC | 21.3% |
| Verizon | 13.8% |

Note: Data from May 2005.

Source: Nielsen Media Research/NSI and Raymond James estimates.

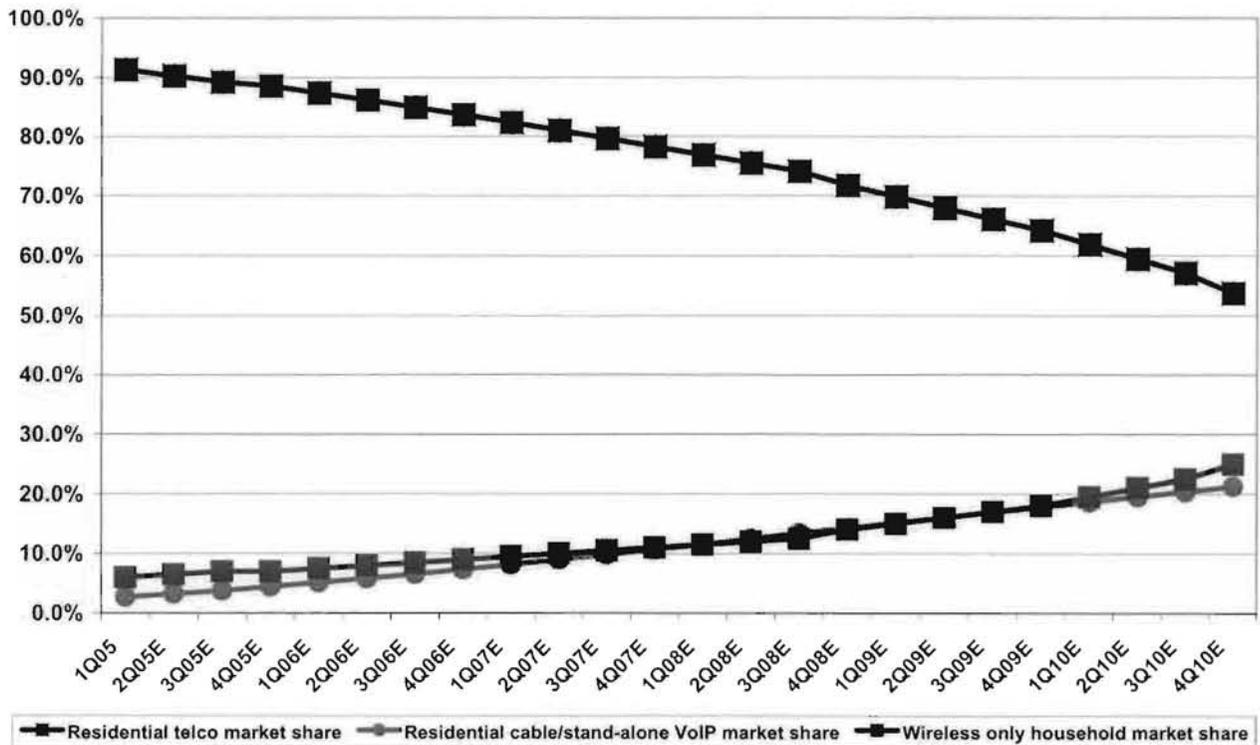
In addition, it remains to be seen what occurs with respect to stand alone VoIP competition. While Vonage is currently the only meaningful provider with a large number of paying VoIP customers in the U.S., to our knowledge, we believe services like Skype could represent more concerning alternatives over time. The company currently has around 125 million people who have downloaded the service worldwide (last time we checked the site, the company claimed to be adding new downloads at a pace of around 150,000 per day) and the functionality of the service is becoming increasingly strong.

We recently tested the free service from Skype and found the voice quality to be extremely strong. The company is trialing a service to download actual phone numbers for an annual fee so that users can more easily receive calls on their Skype phone from traditional phones. The PC to PC functionality with the ability to instant message also is an attractive feature and the service is being used in a number of different capacities, by both business and residential customers. We also note companies like Yahoo! are also deploying a PC to PC VoIP service, which may increase its' popularity among consumers in the U.S.

Combining the Two Substitution Factors to Make a Forecast

All of that being said, with "Skype-like" services being the wild-card, following we forecast the market for household telephony consumption in the U.S. through 2010. We use an operator by operator analysis for cable providers and stand-alone VoIP services in determining our projections based on current trends and expected market entrances over the next 18 months, while we forecast continued steady wireless substitution going forward as well. The point of our exercise is to demonstrate how much the market for traditional residential access lines could deteriorate over the next five years, and while the rate of decline could vary or be stretched out by a year or two, we believe this is the scenario that the industry is headed towards.

Household Market Share Estimates - 2005E - 2010E



Source: Raymond James estimates.

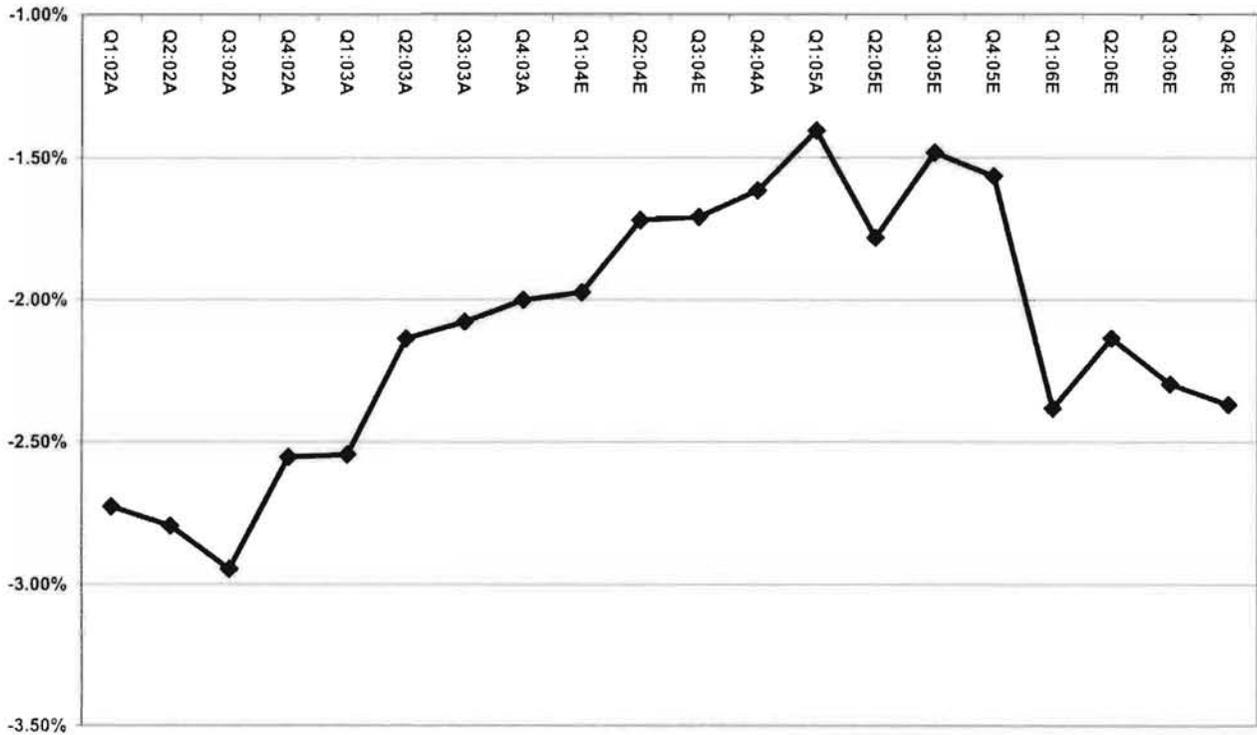
RBOCs vs. Rural ILECs: Substitution Converging or Diverging?

As we point out in our opening comments, the impact of wireless substitution has converged for the rural ILECs when compared to the RBOCs over the past few years, in our opinion. While a number of rural ILECs face pockets of competition (such as Citizens in Rochester and Iowa Telecom facing overbuilders in a handful of markets), to a large extent their access line losses

have been due to wireless substitution and second line losses, in our opinion. The RBOCs generally have greater but decreasing exposure to this second line factor, which explains part of the trend. However, it is our thought that the convergence of year-over-year line losses prior to a major explosion of cable competition can largely be explained by the rural ILECs' wireless substitution "factor" converging with that of the RBOCs.

Following is a graph of the spread between the RBOCs' switched access line losses on a year-over-year basis and the rural ILECs year-over-year loss percentage. We note the spread bottomed in 3Q02 at a 3% absolute difference and has risen up through 1Q05. Our current estimates call for a divergence in this spread going forward due to increases in cable competition expected for the RBOCs relative to the rural ILECs.

RBOC vs. RLEC Line Loss Comparison

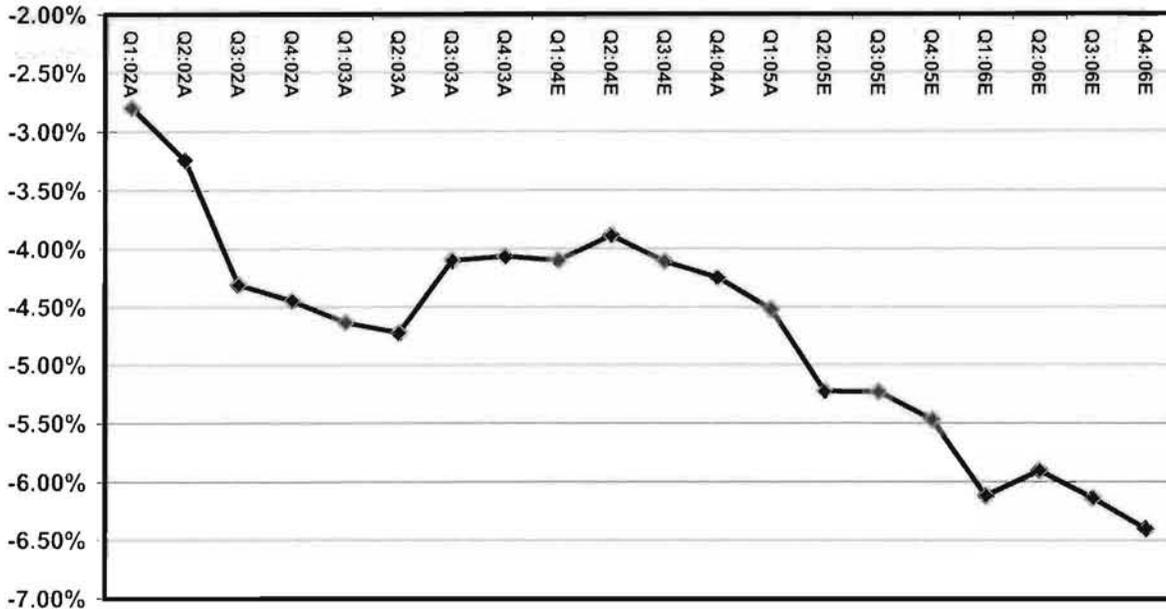


Note: RBOC lines are defined as switched access lines for Verizon, SBC, BellSouth, Qwest, and Sprint. Rural ILEC lines include urban operator Cincinnati Bell.

Source: Raymond James Estimates and Company Reports.

The convergence in line losses on a year-over-year basis has been due to 1) rural ILEC line loss acceleration and 2) RBOC line losses slowing as second line disconnects reach their peak. Following we show each entities year-over-year line losses and absolute rural ILEC line losses.

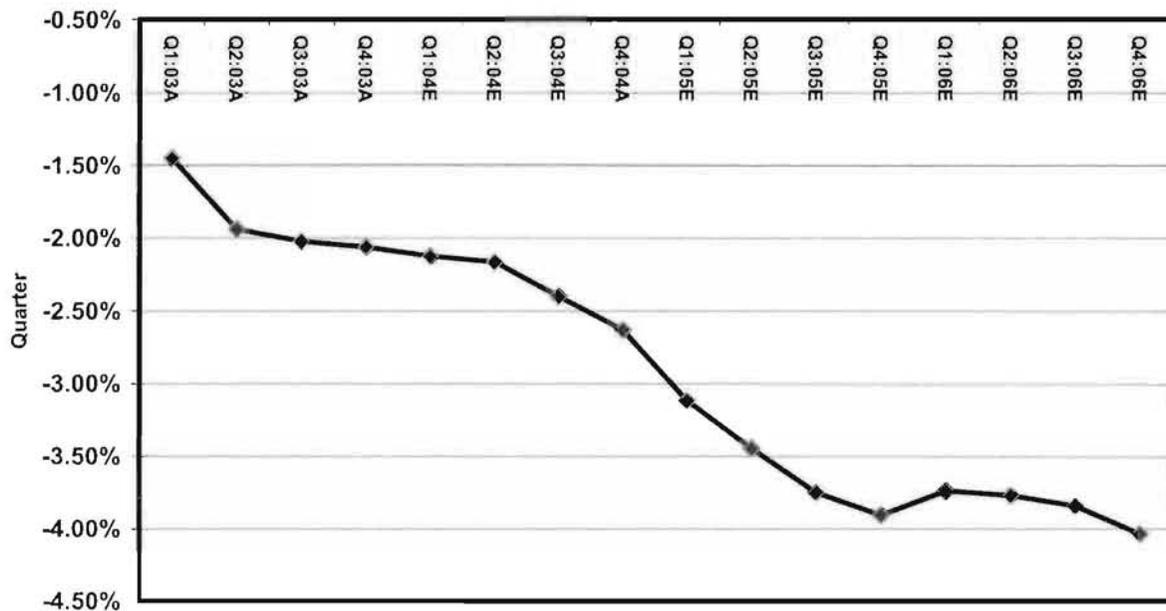
RBOC Line Losses



Projected Y/Y Line Decline
* Access Line Counts for BellSouth, SBC, Verizon, Qwest, and Sprint
 Source: Company Reports and RJA Estimates

Source: Raymond James estimates and Company Reports.

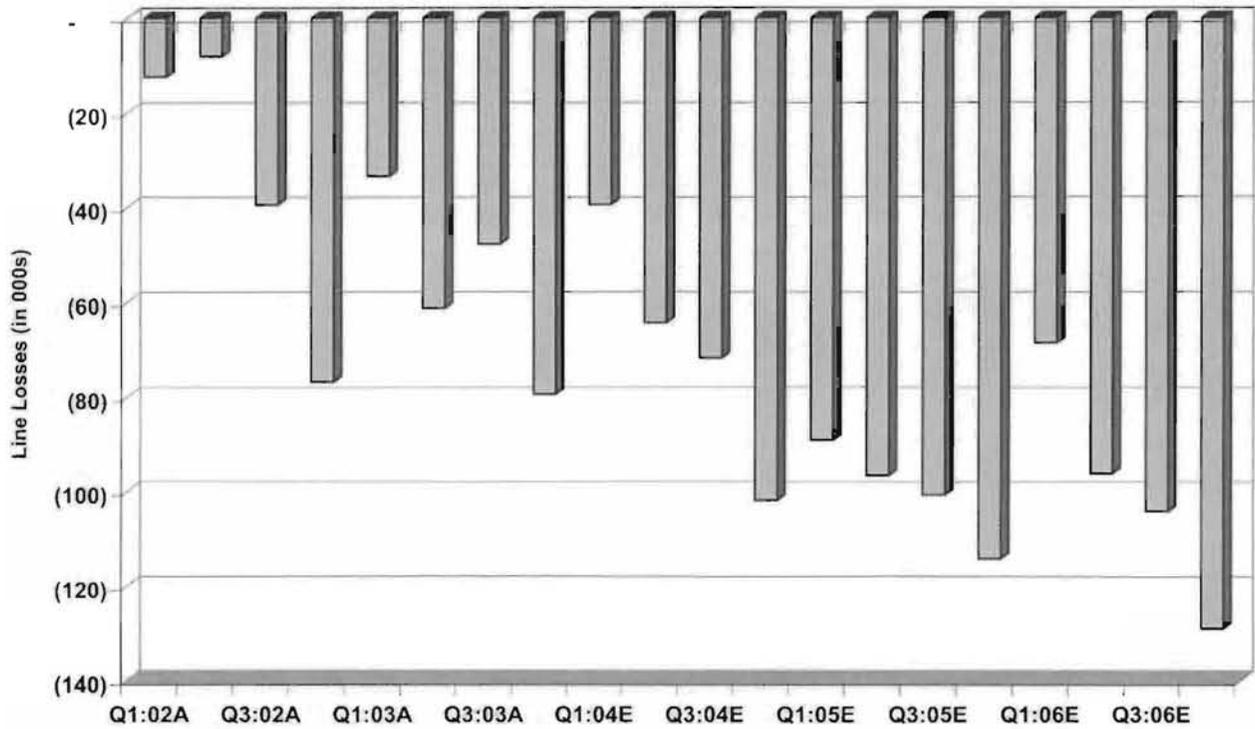
Rural ILEC Line Losses



Projected Y/Y Line Decline
* Access Line Counts for ALLTEL, Glaziers, CenturyTel, Cincinnati Bell, TDS, Commonwealth Telephone, CT Communications, Alaska Communications, Iowa Telecom
 Source: Company Reports and RJA Estimates

Source: Raymond James estimates and Company Reports.

Absolute Rural ILEC Access Line Losses - 2002A - 2006E



ILECs included are AT, CTL, CZN, TDS, CTCO, CTCI, ALSK, IWA, VCG, and CBB.

Source: Raymond James estimates and Company Reports.

Are Access Lines the Drivers We Think They Are?

Consumer voice stakes higher for rural ILECs. With line losses converging to date for the rural ILECs and the RBOCs, this trend bodes poorly for the rural ILECs, in our opinion. The rural ILECs have significantly higher leverage to consumer voice revenue. For instance, below we highlight voice/data revenue mix for the rural ILECs, which generally have a 75%/25% consumer/business access line mix vs. the RBOCs at around 65%/35%.

Data as a Percentage of Total ILEC Revenue

| | Q1'05 | 2005 | 2006 |
|-----|--------------|-------------|-------------|
| CTL | 12.7% | 12.8% | 13.7% |
| CZN | 7.7% | 8.6% | 11.4% |
| VCG | 6.0% | 6.9% | 9.6% |
| VZ | 21.8% | 22.2% | 24.1% |
| BLS | 25.7% | 26.2% | 29.2% |
| SBC | 30.3% | 31.2% | 33.6% |
| CBB | 28.0% | 27.7% | 28.6% |

Note: Verizon and SBC data estimates exclude any potential contributions from IXC acquisitions for comparability purposes.

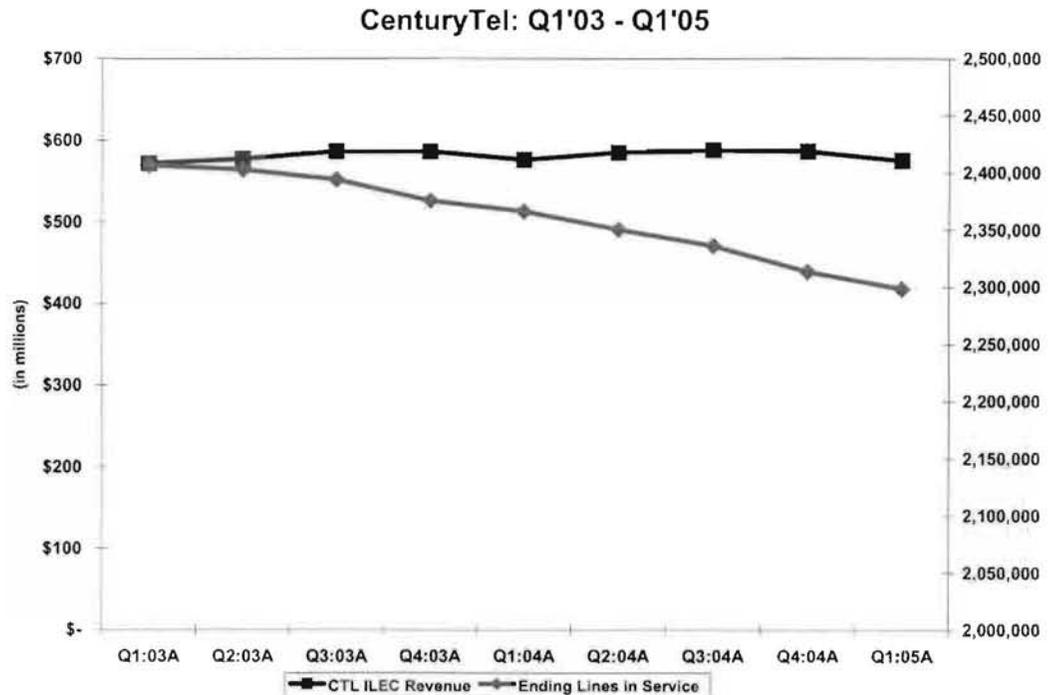
Source: Raymond James estimates and Company Reports.

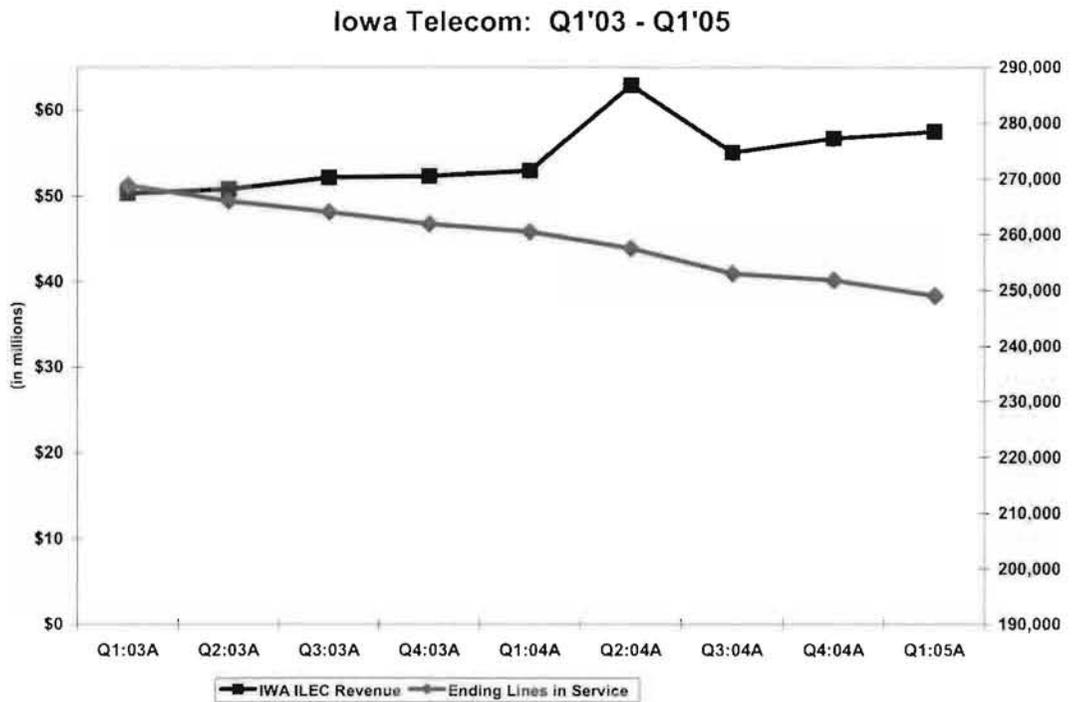
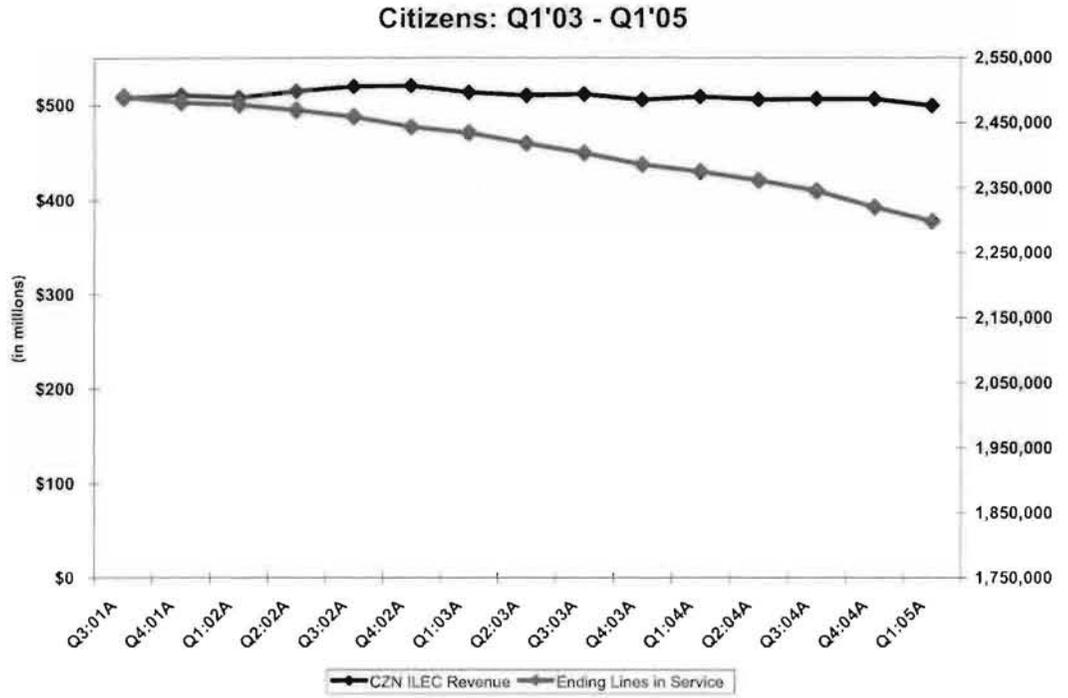
As shown above, with data being a significantly higher portion of revenue, the RBOCs' businesses are driven to a much lesser extent by traditional voice revenue streams. In addition, the RBOCs' and Cincinnati Bell have a greater ability to influence their aggregate revenue base with trends in data, which includes special access services to business and wholesale customers, as well as xDSL. While sales of xDSL are currently contingent on the consumer having an access line, we do not believe this will necessarily be the case going forward as the RBOCs prepare to actively pursue the wireless substitution market by offering naked xDSL, and (when they can) naked xDSL/wireless bundles.

Meanwhile, the rural ILECs generate significantly more revenue per access line, when you add up xDSL, long-distance, basic voice, vertical services, directory services, access and USF. Currently, without an access line, all of these different revenue streams (with the exception of directory) are non-existent. It is our view that access lines lost to wireless substitution are intuitively less valuable lines, because people disconnecting for wireless are likely not using their wireline phone a lot and take less additional services on their basic lines, and generate less access revenue.

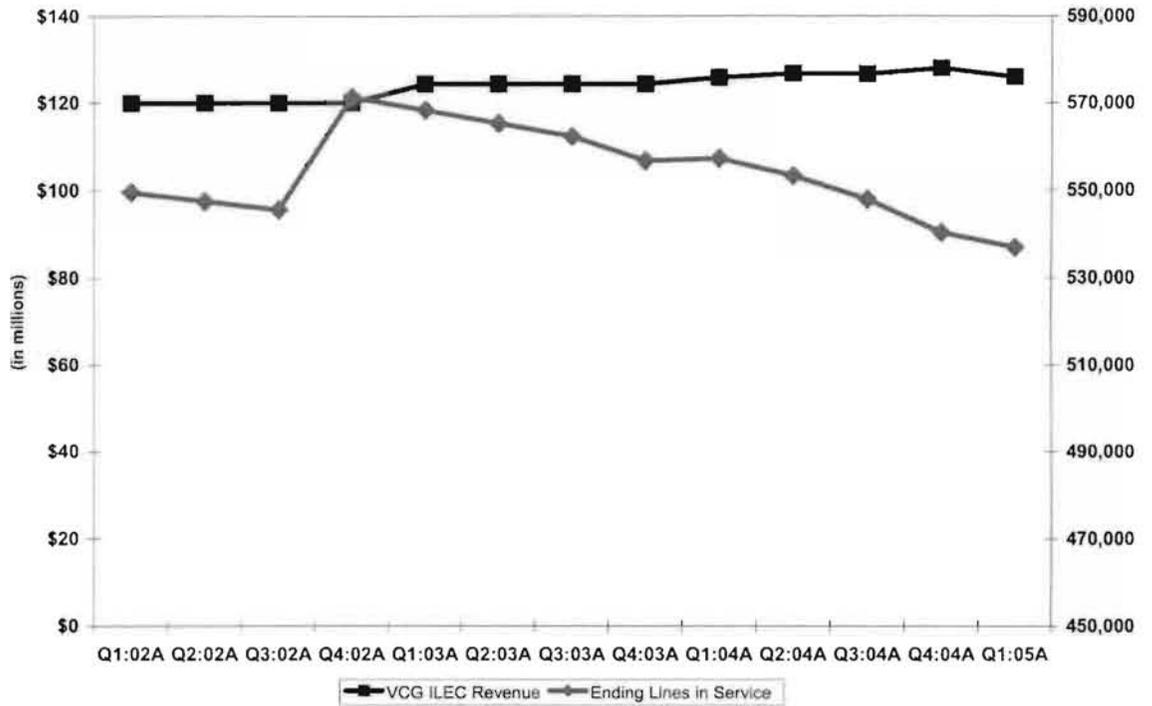
However, in many cases the rural ILECs do lose USF when lines are displaced by wireless, as well as network access revenue associated with usage. Fortunately, to date, the lines being lost for the rural ILECs appear to have been disproportionately lower value lines in less rural areas, with lines in their more urban areas generally producing less in subsidy revenue. For all of these reasons, revenue per line continues to rise due to an access line mix shift. In addition, the lines lost are predominantly residential, which increases their business/residential mix, which in turn increases revenue per access line. We also note the deployment of Internet access (both dial up and broadband) has forced some independent rural ISP's out of business, thus removing low ARPU wholesale lines from the access line count (and boosting ARPU) as a result.

The paradox of declining access lines and flat to increasing revenue
 The result of all of this is that revenue (and in some cases, revenue growth) has declined at a slower rate than access lines, which is likely to continue, in our opinion. Finally, with revenue streams currently staying somewhat steady, the rural ILECs have to date been able to offset access line declines with upselling additional services to their embedded underpenetrated customer base. This is a very interesting point, in our opinion, as it contradicts conventional wisdom in telecom that access line declines have a direct correlation with the demise of business. Would revenue and EBITDA grow significantly higher without line losses? The answer is, of course, yes, but the ability demonstrated by the ILECs and the RBOCs to continue to drive revenue from the existing base is impressive, and bears some consideration when forming opinions as to the longer term health of these companies. All of these trends are demonstrated in the following graphs, which show access lines declining over the past year while revenue stays flat to up for most of the rural ILECs.

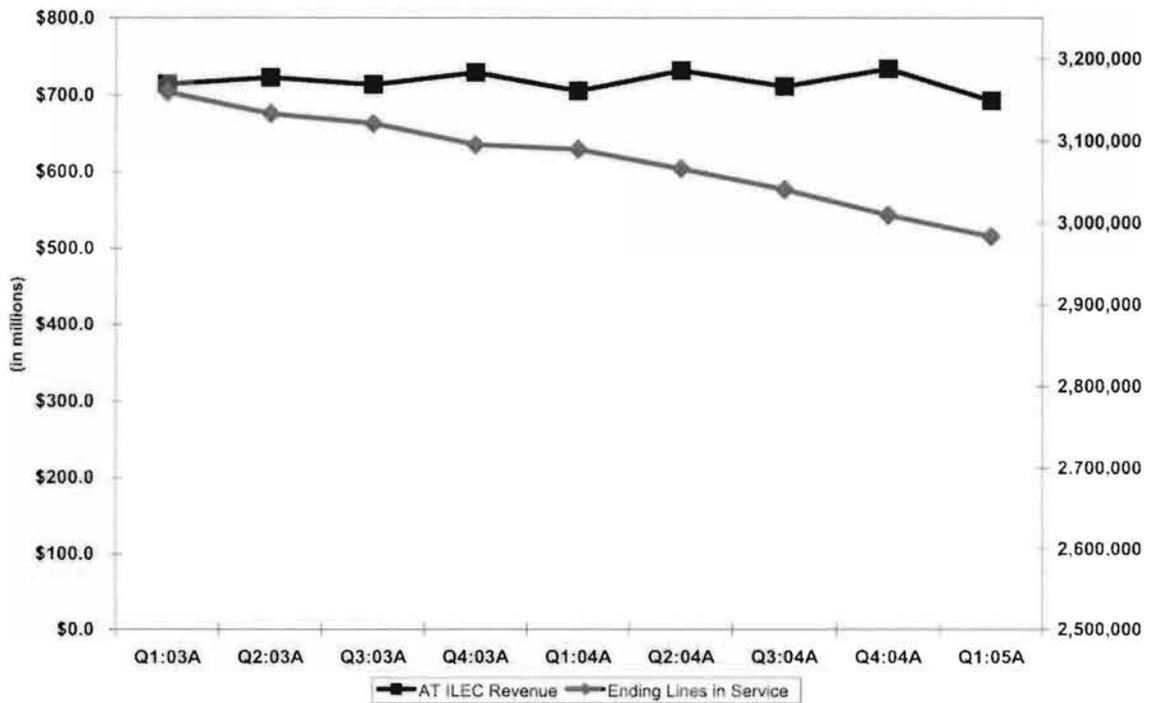




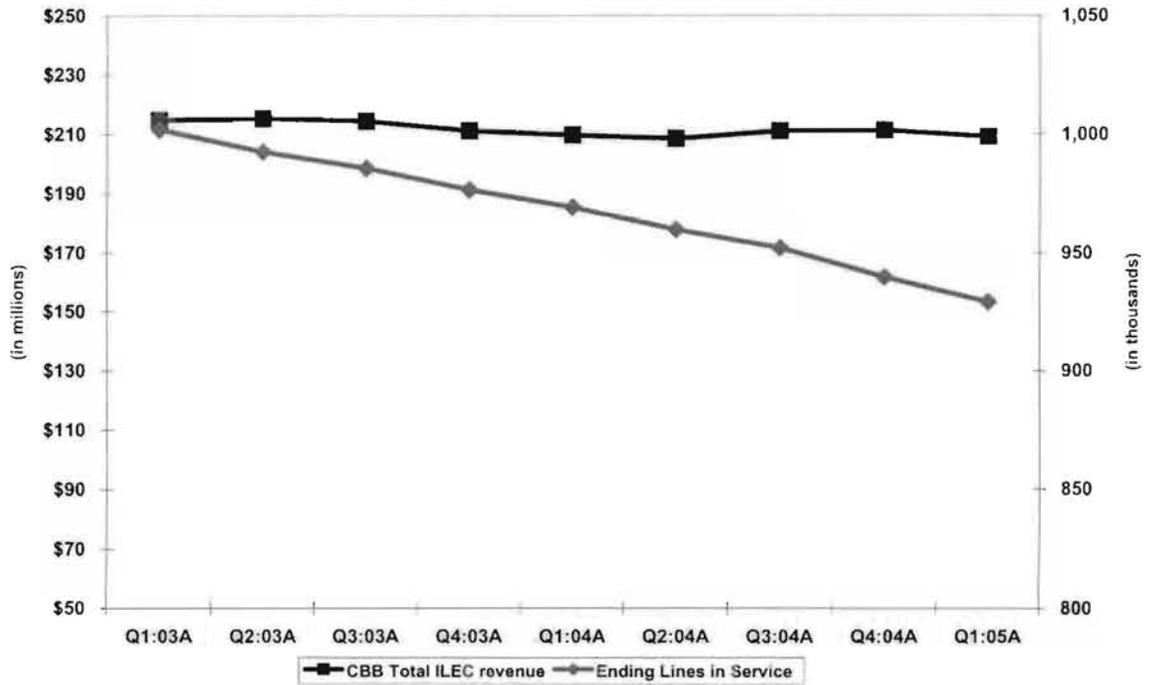
Valor: Q1'03 - Q1'05



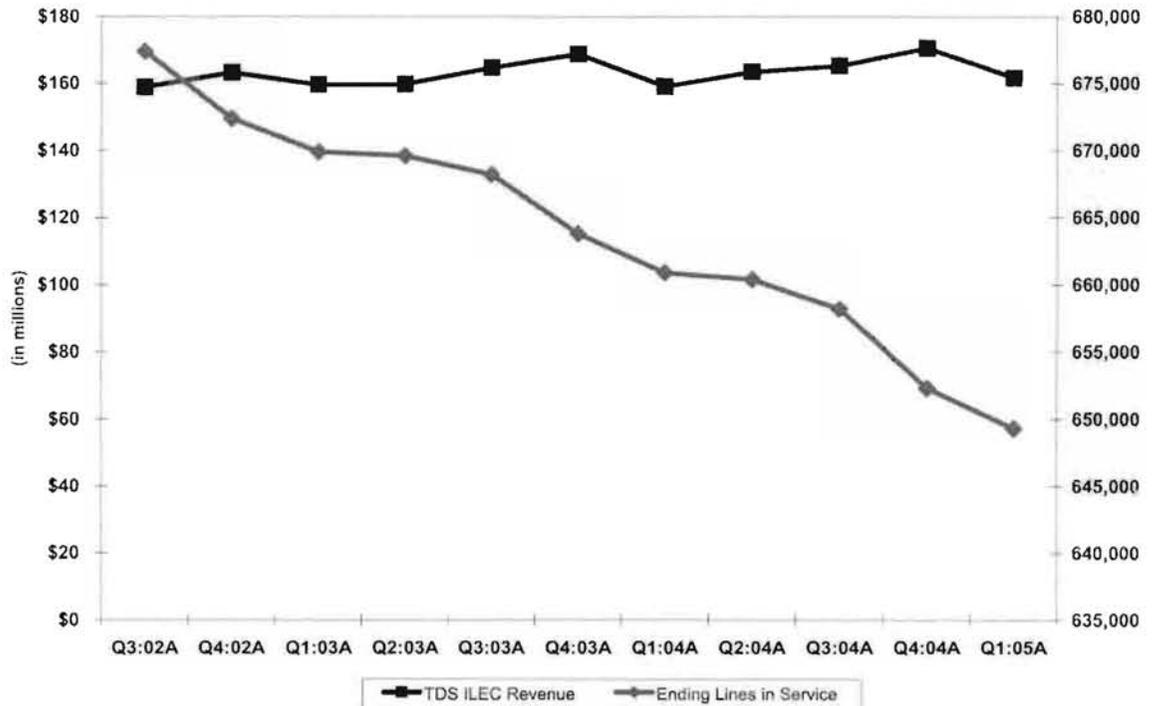
ALLTEL: Q1'03 - Q1'05



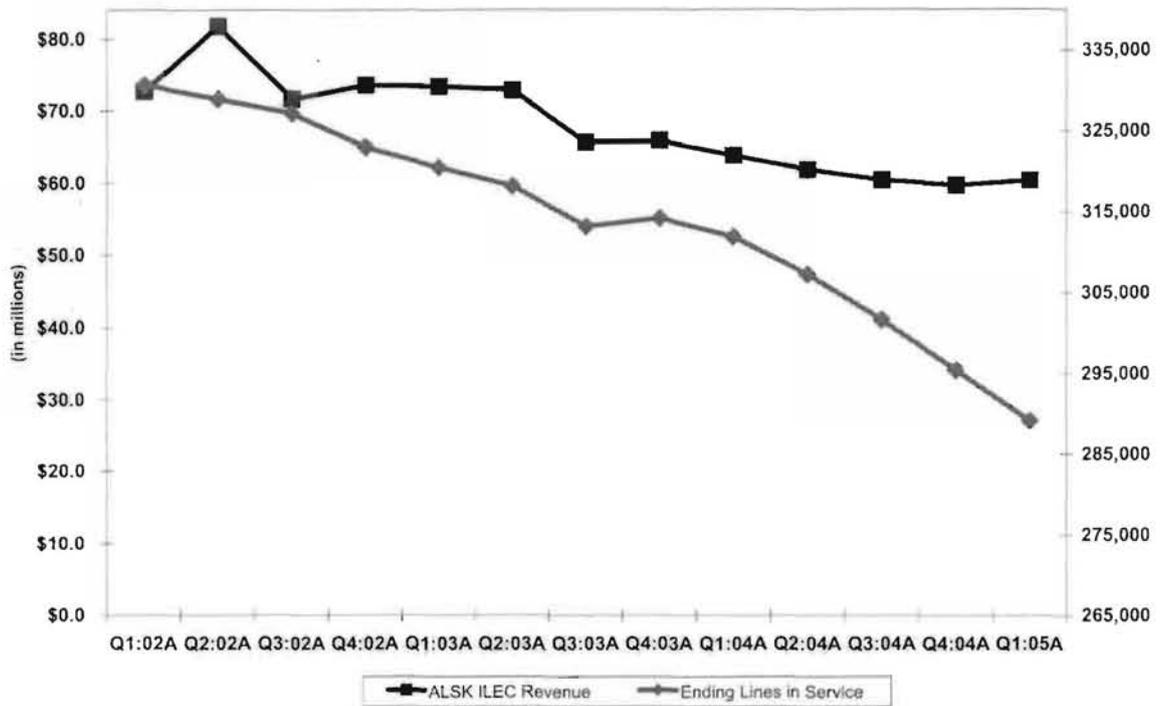
Cincinnati Bell: Q1'03 - Q1'05



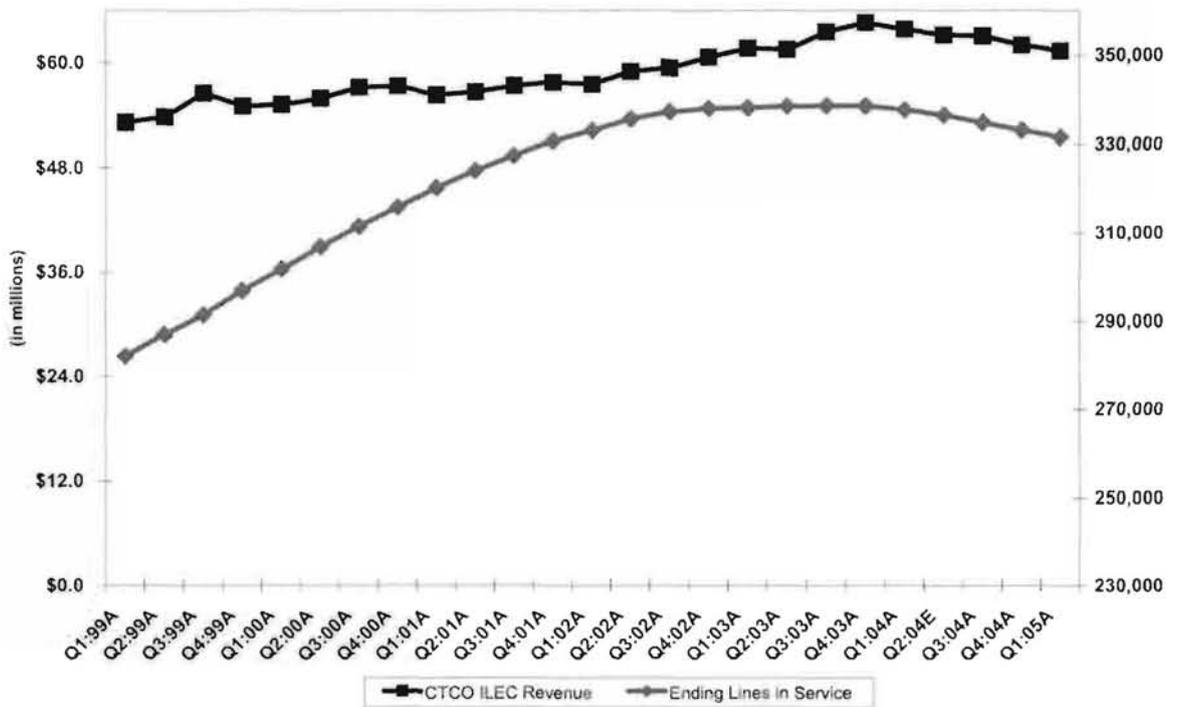
TDS: Q3'02 - Q1'05



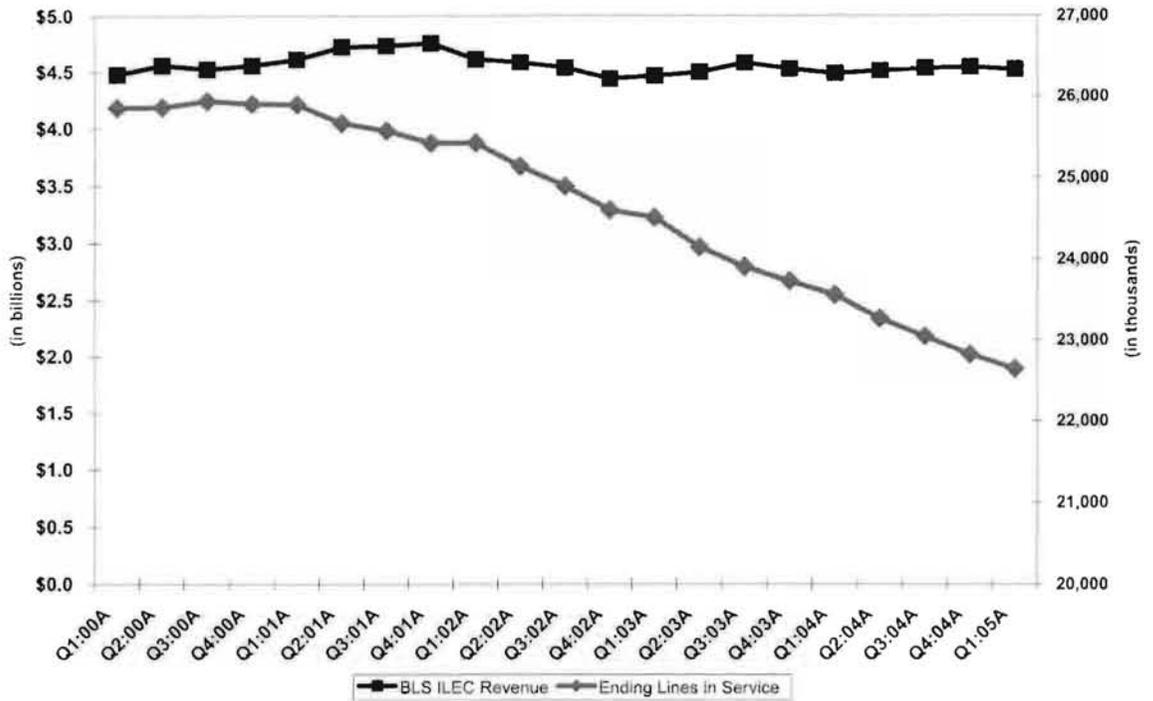
Alaska Communications: Q1'02 - Q1'05



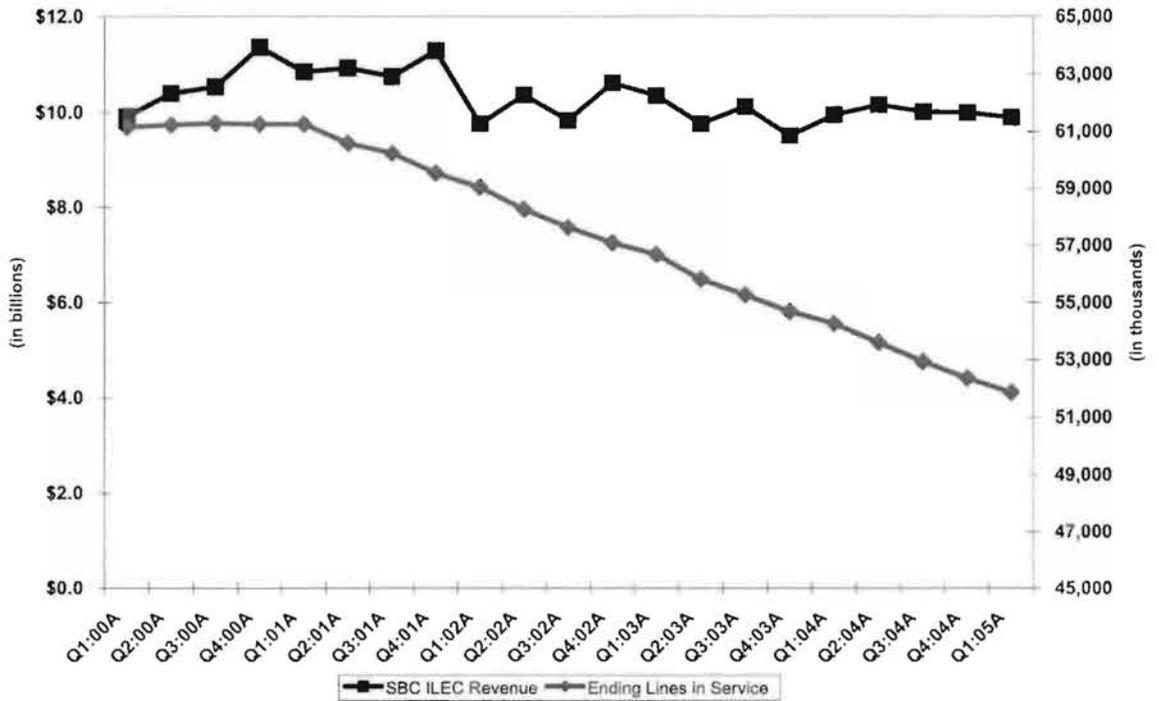
Commonwealth: Q1'99 - Q1'05

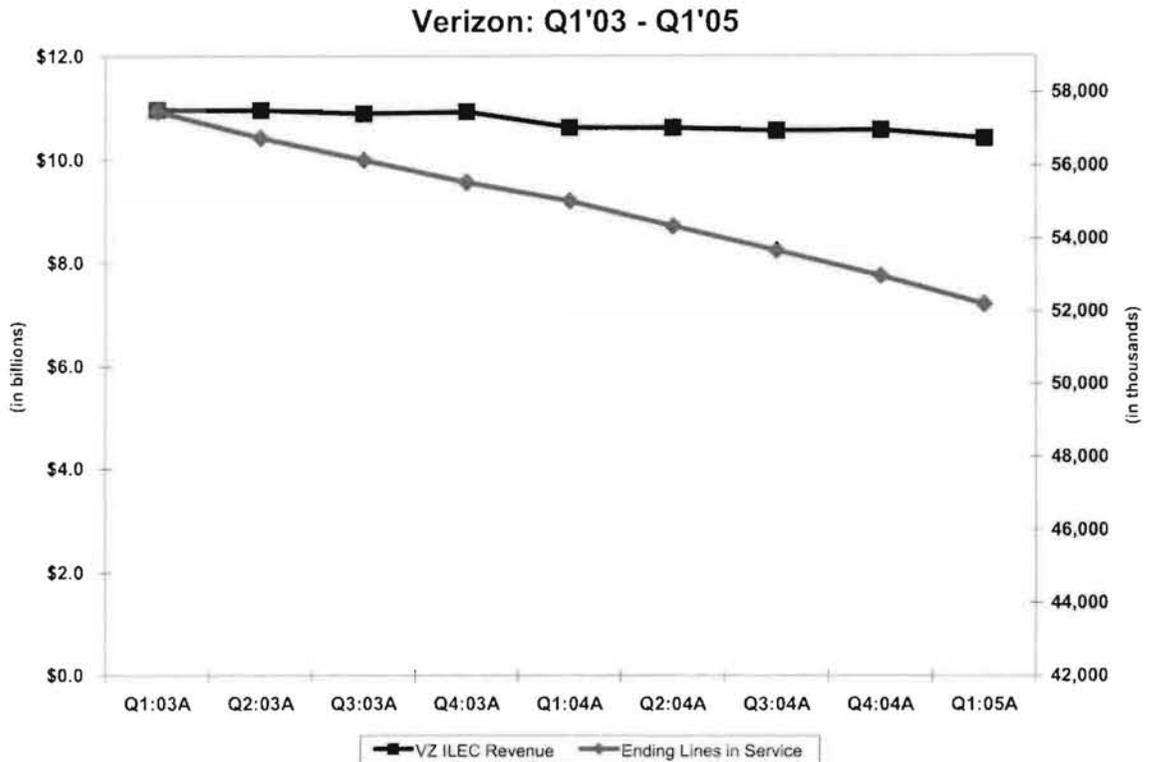


BellSouth: Q1'00 - Q1'05



SBC: Q1'00 - Q1'05





Source: Raymond James estimates and Company Reports.

Periods were chosen to reflect our view of the cleanest data available post the majority of significant acquisitions and divestitures of access lines among the carriers shown.

How long will these ARPU trends continue as access line losses accelerate? The bear case for the rural ILECs, in our opinion, is that as access line losses accelerate (if you accept the proposition that they are accelerating), the ability to sell additional services into their base tops out. While xDSL still represents a significant opportunity, the ability to “move the needle” in this business relative to their embedded revenue per access line is somewhat limited. Meanwhile, long-distance penetration within their customer bases has grown substantially over the past few years and further incremental penetration of vertical services is likely to be at a slower pace. Finally, the potential benefits from these revenue sources could be offset by pressure on USF and intercarrier compensation revenue per line. Since USF is based on access lines in rural areas that can be disaggregated down to the wire-center level, acceleration in wireless substitution in more rural markets could cause USF erosion to accelerate as well.

We also note the impact rate-of-return regulation has on average revenue per line as access lines decline for carriers regulated under rate-of-return. We believe rate-of-return carriers have seen access revenue per line (the rate-of-return mechanism) come up as access lines come down. In other words, rate-of-return access revenue is not based on access lines, only USF and

volume driven access revenue is impacted by lines (for more information on regulatory factors that impacts the rural ILECs, please see our report on 04/08/05 titled *Rural ILECs: Analyzing the Differences*). So access revenue per line goes up as lines go down. This factor is mainly impacting Fairpoint, ALLTEL, and CenturyTel, with carriers like Iowa Telecom, Valor Communications, and Citizens regulated under price cap regulation.

The Critical Fight for the Broadband Anchor

xDSL Growth is Key. We have asserted for the past couple of years that broadband is clearly the anchor product for both the telcos and for cable. For this reason, we are not surprised by recent moves by SBC and Verizon to offer significant discounts on xDSL pricing, as we believe broadband is the stickiest product relative to basic voice or video. Going forward, this will be critical for the RBOCs, particularly as they need to protect their market share. In addition, we actually would go as far to assert the **rural ILECs should be offering even lower prices than the RBOCs for xDSL service in many of their markets**, as it provides consumers with incentive to keep their access lines, which generate significantly higher revenue streams.

While this final concept is not intuitive at first, lets take a longer look at ARPU for the rural ILECs and what they generally give up when they lose an access line. As we previously point out, all access lines are not created equal. However, we believe many of the rural ILECs' access lines have ancillary revenue streams associated with them, namely USF and access. Following we highlight ILEC ARPU estimates for 1Q05 for a number of rural ILECs and RBOCs.

| <i>ARPU Summary</i> | | | |
|---------------------|-------------------|----------------|-------------------|
| Company | Q1'05 ARPU | Company | Q1'05 ARPU |
| CZN | \$72.40 | VZ | \$66.39 |
| CTL | \$83.39 | CBB | \$75.05 |
| VCG | \$78.17 | TDS | \$83.05 |
| IWA | \$76.98 | ALSK | \$69.57 |
| AT | \$77.39 | CTCO | \$61.74 |
| BLS | \$66.55 | SBC | \$63.57 |

Source: Raymond James estimates and Company Reports.

With the rural ILECs generating over \$70 to \$80 per line per month in some cases, keeping these revenue streams in tact is key, in our opinion. It is our thinking that the ILECs, especially in more rural areas where xDSL deployment is possible, must incent their customer bases to retain their telephony line. The reason it is key in more rural markets is the USF revenue stream associated with these lines. Thus, if the rural ILECs were to offer xDSL at \$20 per access line (or even \$15 in some cases), this would have the impact of increasing the demand for the service closer to that of the national average, which would greatly increase the number of customers taking the service and generate more absolute revenue for this product line, in our opinion. But more importantly, the rural ILEC would then ensure they keep

their high-value customer, as the xDSL product at a very low price point would incent the customer to retain the phone line they most likely do not need any more. So while the xDSL revenue per line is diminished to around \$20 per month, the company could retain up to \$100 per month in total revenue by offering the discount.

Taking xDSL retention a step further. All of this sounds interesting from a theoretical perspective, but let's do some math. Among covered companies, we estimate the rural ILECs and RBOCs average 9.3% xDSL penetration of total access lines (including business lines). Over time, we believe 30% household penetration of xDSL is not a stretch, especially for the rural ILECs, as xDSL subscribers grew 88% in 2004, compared to cable modem subscribers that grew at only 36% according to the latest data available from the FCC. Also, with inherently lower cable modem competition within their territory, we believe rural ILECs should be able to capture outsized share of total broadband demand. Considering current penetration of broadband in aggregate (cable and xDSL) stands at 32.5% according to the FCC, we see no reason this would not hold true for more rural and suburban markets as well, thus leading us to believe xDSL penetration will be higher on average due to lower overall availability of cable modems in their territories. xDSL pricing varies around the industry, with SBC at \$14.95 with a bundle and Iowa Telecom offering 512k service with an additional service charge and a required two-year agreement at \$39.95. While the impact of SBC's pricing move have yet to be seen, we believe Cincinnati Bell has been the most successful at gaining penetration of the service to date, with 14% penetration of access lines at a \$29.95 price point within the bundle.

For argument's sake, let's say xDSL penetration triples at a \$20 price point, with the service potentially priced slightly below this for residential customers but ARPU being counterbalanced by business xDSL customer bases. Comparing revenue generated per access line currently to this scenario, the average revenue per access line generated would increase by \$2.28 on average due to higher penetration of the service per line. Put another way, prices may decline by more than half in some cases but revenue for the service would be up. We also note this analysis is without the benefit of customer retention we describe above, which is all the more essential for the rural ILECs due to their higher revenue generated per line.

xDSL as an Access Line Loss Shield. The other impact that we believe is overlooked in simple access line loss extrapolation models is the "line loss shield" associated with adding xDSL customers. Yes, as we have pointed out, line losses are accelerating for the rural ILECs, which is a negative. The real question, in our opinion, is when does top line revenue and average revenue per user (ARPU) begin to follow this trend, as we assert access lines in and of themselves are not necessarily the whole picture when looking at wireline business models. As stated above, the demand for broadband and xDSL appears sufficient to drive higher penetration levels over time, especially for ILECs with lower levels of competition.

According to our estimates, the rural ILECs could loose anywhere from 18% to 30% of their households as wireline customers and still retain similar or better levels of top line revenue as long as xDSL penetration reaches 30%. This analysis also assumes the price point is up to 50% lower than current levels, which we believe will incent current dial up customers to stay with the ILEC as they consider upgrading to high speed, as well as attract incremental demand. We also note our assumption only assumes the access line is retained 1/3 of the time by selling xDSL, which is likely a low number considering retention properties of voice and data bundles in the industry. Also, this says nothing of the potential positive impact of an offensive deployment of video via xDSL 2+ (IP TV) at some point in the future. **The bottom line is that**

we strongly suggest xDSL pricing will come down in rural markets, and this will at a minimum offset access line losses, and possibly more than make up for them over the next 5 years. The net result is that, while line losses are not to be taken lightly, the streets current concerns over line erosion and its impact on rural carriers to pay their dividends is a bit overblown.

Rate of change at the incumbents remains slow. We believe to the extent access lines defect, it will be significantly tougher to get the customer back with lower-priced xDSL or any other tactic. Unfortunately, we have heard little talk across the industry of lowering prices to reduce churn and at the same time stimulate demand, especially among rural ILECs. In our view, management teams are generally under the impression that investors would react unfavorably to price cutting in broadband due to the near-term impact on this revenue stream on their embedded customer bases. However, we believe the customer reactions, the repercussions this would have for the regulatory community (i.e. solving the perceived digital divide by offering lower prices), and the longer-term elasticity of demand alone would warrant such a move.

Lastly, the telcos, in general, have a significant advantage in winning the incremental broadband customer in that they own a large amount of the current dial-up customers and all of their connections. Conversion of these lines will be critical, in our opinion, as these customers are not only embedded Internet customers but also represent access lines. This is even more acute for rural carriers where independent ISPs, such as AOL and Earthlink are virtually non-existent. As a side note, we believe quite a few rural carriers have lost a number of business customers in the form of small mom and pop ISPs that have been disappearing due to broadband proliferation, which puts pressure on wholesale lines, but not necessarily on overall revenue.

Conclusions

So what does all of this mean for our coverage universe? First, it looks to us as though the RBOCs fundamentally have revenue streams that appear less susceptible to the changing landscape than the rural ILECs. While we have favored the rural ILECs' for their stability for some time, we believe the RBOCs have already "experienced the pain" of converting their asset bases to reflect the landscape as we expect it to stand in five years. While we expect access line losses at the RBOCs to accelerate further and remain higher than the rural ILECs, their other revenue streams could potentially more than offset this decline.

Second, several years ago, the rural ILECs pointed out their markets tended to lag the RBOCs' markets due to their customers' tendency to be more inert than customers in urban markets. We believe wireless substitution is slowly catching up in rural markets as wireless coverage improves and customers follow the trend of urban markets.

Looking forward, we believe the RBOCs will be increasingly driven by trends in the enterprise market, wireless, and xDSL services. The rural ILECs, however, continue to be driven by access line trends and voice services in the residential market. While rural ILECs remain more protected from the deployment of large amounts of competitive capital, be it from wireless or cable, we believe these competitive forces are increasingly creeping towards them and their need to react now is becoming more apparent.

Third, average revenue per line trends, driven by mix shifts and upselling among existing customers have so far shown little signs of slowing down. However, we believe long-distance upselling opportunities are slowly dissipating in a world where the lines between local and long distance are disappearing. In addition, the next leg of xDSL customer growth is likely be driven by lower pricing, which we believe will have to materialize at some point in the future. Rural ILECs that move more quickly to cut pricing will have a much less painful transition two to three years from now and will retain a growing number of customers to boot. We believe price cuts almost down to \$15 for xDSL could be justified as a way to reverse access line losses and potentially to begin adding lines going forward. Therefore, in our opinion, the incremental penetration of xDSL customers could shield 18% to 30% erosion in household access lines and maintain current levels of revenue.

Lastly, we continue to point investors towards our assertions around access lines and their real impact on ILEC models. Had investors put access line trends in their models from a few years ago that reflected the actual increasing line loss trends, a disastrous scenario would likely have emerged. Therefore, the factors leading the ILECs to consistently drive revenue per line higher each year should be given heavier consideration, in our opinion, as they are an overlooked factor in the consistency of the sector. This is particularly the case for ILECs with high dividend payouts, as line losses are one of the most heavily scrutinized risk factors as those models are questioned in the marketplace, and they are among some of the least penetrated in terms of xDSL subscribers.

To adjust for our analysis in this report, we are increasing our access line loss estimates for ALLTEL, CenturyTel, Citizens, and Iowa Telecom. This has the impact of very slightly lowering our revenue and EBITDA estimates for these companies to varying degrees, although we note the incremental impact on revenue and EBITDA is largely insignificant. We have published separate notes on these companies detailing our estimate changes for each company.

Public companies mentioned in this report.

| Company Name | Ticker | Priced as of 7/8/05 | RJ&A Rating (if Applicable) |
|---|--------|------------------------|--------------------------------|
| Alaska Communications Systems Group Inc. | ALSK | \$10.09 | Market Perform |
| ALLTEL Corp. | AT | \$64.60 | Outperform |
| BellSouth Corporation | BLS | \$26.83 | Market Perform |
| CenturyTel Inc. | CTL | \$33.62 | Market Perform |
| Cincinnati Bell Inc. | CBB | \$4.49 | Outperform |
| Citizens Communications | CZN | \$13.16 | Outperform |
| Commonwealth Telephone Enterprises Inc. | CTCO | \$41.77 | Market Perform |
| CT Communications Co. | CTCI | \$13.10 | Market Perform |
| Earthlink Inc. | ELNK | \$9.14 | |
| Fairpoint | FRP | \$16.21 | |
| Iowa Telecommunications | IWA | \$18.81 | Outperform |
| Qwest Communications Intl. | Q | \$3.63 | Underperform |
| SBC Communications, Inc. | SBC | \$23.57 | Underperform |
| Sprint Corporation | FON | \$25.38 | |
| Telephone and Data Systems, Inc. | TDS | \$40.65 | Underperform |
| Time Warner, Inc. | TWX | \$16.42 | |
| Valor Communications Group | VCG | \$13.99 | Outperform |
| Verizon Communications | VZ | \$34.40 | Market Perform |
| Yahoo | YHOO | \$34.62 | |

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| Company Name | Disclosure |
|--|---|
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| BellSouth Corporation | Raymond James & Associates participated in a public offering of preferred equity for BLS in January 2003. |
| CenturyTel Inc. | Raymond James & Associates co-managed public debt offerings for CenturyTel Inc. in August 2002 and February 2005. Raymond James & Associates received non-investment banking securities-related compensation from CTL within the past 12 months. |
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Wireline telecom services remain highly regulated, and should regulation become less favorable, promoting more competition or reducing subsidies for these companies, the sector could be negatively impacted. Technological substitution remains a highly credible threat toward most wireline telecom services companies' revenue and earnings. A large amount of debt could leverage the industry to the downside should earnings and cash flows face significant pressure.

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