

D&E Statement No. 1
Docket No. P-00981428F1000

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DIRECT TESTIMONY

OF

LEONARD J. BEURER

DENVER AND EPHRATA TELEPHONE AND TELEGRAPH COMPANY

CONESTOGA TELEPHONE AND TELEGRAPH COMPANY

BUFFALO VALLEY TELEPHONE COMPANY

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

1 **Q. Will you please state for the record your name, business address,**
2 **occupation, and by whom you are employed?**

3 A. My name is Leonard J. Beurer. My business address is 124 East Main
4 Street, Ephrata, PA 17522-0458. I am employed by D&E
5 Communications, Inc. ("D&E") as Vice President – Regulatory Relations
6 and External Affairs.

7 **Q. How long have you held this position?**

8 A. I have been employed by D&E Communications in this position since
9 August of 2004.

10 **Q. Please state your educational background and employment**
11 **experience.**

12 A. I hold a Bachelor of Arts Degree in Accounting from the University of
13 Northern Iowa and a Masters Degree in Business Administration from
14 Drake University. I joined D&E Communications, Inc. in August of 2004
15 with primary responsibilities including Federal and State regulatory issues,
16 Federal and State tariff issues, Carrier Access Billing, settlement issues
17 involving Pennsylvania ITORP and National Exchange Carrier Association
18 ("NECA") pools, Federal and State Universal Service Fund issues and
19 compliance filings, Interconnection Agreements, Revenue Assurance
20 projects, Access Expense Bill Validation and financial analysis and budget
21 preparation. I am currently a member of the USTelecom Regulatory
22 Tactics committee, USTelecom Telecom Policy Committee, NECA
23 Industry Average Schedule Task Group Committee, Pennsylvania

1 Telephone Association ("PTA") Intercompany Operations Committee, PTA
2 Chapter 30 Working Group and PTA Small Company Committee.

3 Prior to joining D&E Communications, Inc., I was a Vice President
4 with VALOR Telecommunications, headquartered in Irving, Texas. I was
5 responsible for all Federal regulatory and tariff filings, Federal and State
6 Universal Service fund issues and compliance filings, ILEC Industry
7 Relations agreements, Competitive Carrier Interconnection agreements
8 and VALOR's Wholesale Customer Service Center, responsible for taking
9 and processing competitive carrier service orders.

10 Prior to joining VALOR, I was Staff Manager of Access Tariffs with
11 ALLTEL. In this capacity I was responsible for all Federal tariff filings and
12 rate development and I assisted the State Regulatory group on all issues
13 regarding State Access tariffs and State Universal Service Funds. While
14 at ALLTEL I was an active participant in the Pennsylvania Public Utility
15 Commission's ("PaPUC") Global Telecommunications Settlement
16 Conferences and was actively involved in the development of the rural
17 carriers' compliance schedules, having the responsibility to collect data
18 and develop worksheets that calculated new carrier access amounts for all
19 rural carriers in accordance with the parameters that established the new
20 state access rates, local service rates, intraLATA toll rates and the
21 Pennsylvania Universal Service Fund ("PaUSF").

22 My entire work experience has been in the Telecommunications
23 industry, having started with GTE in 1978. I have previously testified on
24 topics including settlements, access rates, Universal Service Funds and

1 Interconnection issues in the states of Texas, New Mexico, Arkansas,
2 Missouri and Florida.

3 **D&E Carriers**

4 **Q. Will you give a brief corporate history of D&E?**

5 A. D&E is a holding company with three wholly-owned incumbent rural local
6 exchange carrier ("ILEC") subsidiaries, Denver and Ephrata Telephone
7 and Telegraph Company ("D&E Telephone"), Conestoga Telephone and
8 Telegraph Company ("Conestoga"), and Buffalo Valley Telephone
9 Company ("Buffalo Valley"), hereinafter collectively "D&E carriers." D&E
10 is a member of good standing in the central Pennsylvania corporate
11 community. Its rural ILECs and other subsidiaries endeavor to provide our
12 customers with advanced communications services. D&E is proud to
13 consider itself as a provider of quality integrated communications services
14 to residential and business customers. D&E Telephone was the first ILEC
15 in Pennsylvania to deploy a 100% digitally switched network. D&E
16 employs approximately 550 people most of which are Pennsylvania
17 residents and all are dedicated to meeting the communications needs of
18 our customers. D&E takes its service responsibilities seriously and its
19 regulatory decisions are made in good faith and with the objective of
20 assuring that its subsidiaries, including its rural ILECs, retain the fiscal and
21 technological wherewithal to satisfy customer needs. The D&E carriers
22 have committed under Act 183 to bring 100% broadband availability to
23 their service territories by December 31, 2008. We made this commitment
24 with the belief that access services are protected services under our

1 Amended Chapter 30 Plans and may be increased pursuant to the
2 provisions of our Chapter 30 plan formulas provided the carrier charge
3 rates do not exceed the \$7.00 Global Order benchmark and our switched
4 access rates mirror interstate rates. Now, D&E must expend significant
5 dollars in litigation in lieu of investing those dollars in its network. D&E,
6 however, elected to proceed with this litigation because it is absolutely
7 committed to providing quality communications services to its rural service
8 territories.

9 **Q. Please generally describe D&E's three rural ILEC subsidiaries.**

10 A. D&E Telephone is a rural ILEC providing telecommunications services to
11 the public in portions of Berks, Lancaster and Lebanon Counties,
12 Pennsylvania. Presently, D&E Telephone serves approximately 56,000
13 access lines of which 68% are residential customers.

14 Conestoga is a rural ILEC providing telecommunications services to
15 the public in portions of Berks, Chester, Lancaster, Lehigh, and
16 Montgomery Counties, Pennsylvania. Presently, Conestoga serves
17 approximately 53,500 access lines of which 75% are residential
18 customers.

19 Buffalo Valley is a rural ILEC providing telecommunications
20 services to the public in portions of Union and Northumberland Counties,
21 Pennsylvania. Presently, Buffalo Valley serves approximately 20,000
22 access lines of which 70% are residential customers.

1 **Procedural History**

2 **Q. On May 3, 2006, did the D&E carriers file their annual Chapter 30**
3 **filings ("2006 Filings") with the PaPUC?**

4 A. Yes, on May 3, 2006, D&E Telephone filed its annual Chapter 30 Price
5 Stability Index/Service Price Index ("PSI/SPI") filing increasing revenues
6 on the basis of changes in the Gross Domestic Product Price Index
7 ("GDPPI"). The changes allowed D&E Telephone to increase its
8 noncompetitive service rates to produce a 3.70% increase in annual
9 noncompetitive service revenues. The rate changes proposed in the
10 accompanying tariff supplements included (i) increases in switched
11 intrastate access service charges through a \$1.20 increase in the Carrier
12 Charge ("CC") and increases of \$.00099 per Minute of Use ("MOU") for
13 Tandem Switching ("TS") and \$0.00636 per MOU for Local Switching
14 ("LS") to mirror the company's interstate rates and (ii) increases in various
15 non-basic local service rates.

16 On May 3, 2006, Conestoga filed its annual Chapter 30 PSI/SPI
17 filing increasing revenues on the basis of changes in the GDPPI. The
18 changes allowed Conestoga to increase its noncompetitive service rates
19 to produce a 3.70% increase in annual service revenues. The rate
20 changes proposed in the accompanying tariff supplements included (i)
21 increases/decreases in switched intrastate access service charges
22 including a \$0.33 decrease in the CC and increases of \$.000962 per MOU
23 for TS and \$0.007644 per MOU for LS to mirror these traffic sensitive

1 rates with its interstate rates and (ii) increases in various non-basic local
2 service rates.

3 On May 3, 2006, Buffalo Valley also filed its annual Chapter 30
4 PSI/SPI filing increasing revenues on the basis of changes in the GDPPI.
5 The changes allowed Buffalo Valley to increase its noncompetitive service
6 rates to produce a 3.70% increase in annual noncompetitive service
7 revenues. The rate changes proposed in the accompanying tariff
8 supplements included (i) increases in switched intrastate access service
9 charges through a \$0.97 increase in the CC and increases of \$0.002402
10 per MOU for TS and \$0.000247 per MOU for LS to also mirror its
11 interstate rates, (ii) a per line increase of \$0.30 in basic local services, and
12 (iii) increases in various non-basic local service rates.

13 **Q. Were the rate changes proposed in the 2006 Filings permitted to**
14 **become effective?**

15 A. Yes, as adjusted. By Opinions and Orders entered June 23, 2006 ("June
16 23 Orders"), the PaPUC permitted the proposed rate changes to be
17 implemented if adjusted for a change in the D&E carriers' long-established
18 PSI/SPI procedure for calculating the annual revenue allowance.
19 Specifically, the PaPUC directed that our rural carriers change the manner
20 in which they calculated their base revenues for determining their annual
21 revenue entitlement. Historically in our PSI/SPI filings the D&E carriers
22 calculated their annual revenue entitlement based on annualized
23 December revenues. The June 23 Orders directed the D&E carriers to
24 change that methodology by calculating the annual revenue entitlement to

1 be based on actual revenues for the year. The PaPUC also raised
2 questions concerning the intrastate access charge increases and directed
3 that if the D&E carriers elected to implement the increases (as modified) in
4 intrastate access charges in lieu of banking or further increasing basic
5 exchange rates, such questions would be addressed in the pending
6 *universal service fund and intercarrier compensation investigation* at
7 Docket No. I-00040105. The D&E carriers on June 28, 2006, filed rates
8 consistent with their 2006 Filings as modified pursuant to the June 23
9 Orders ("June 28 Compliance Filings"). The compliance tariffs were
10 permitted to become effective on July 1, 2006.

11 **Q. Please summarize the rate changes implemented pursuant to the**
12 **June 23 Orders.**

13 A. The June 28 Compliance Filings are summarized as follows: (i) D&E
14 Telephone reduced its annual Chapter 30 revenue entitlement sought in
15 its 2006 Filing by \$46,575 from \$1,022,608 to \$976,033. D&E Telephone
16 also reduced its proposed CC increase from \$1.20 per line to \$1.13 per
17 line and retained the mirroring of its interstate switched access rates and
18 the non-basic service rate increases originally proposed; (ii) Conestoga
19 reduced its annual Chapter 30 revenue entitlement by \$40,738 from
20 \$917,330 to \$876,592. Conestoga raised its proposed CC decrease from
21 \$0.33 per line per line to \$0.39 per line and retained the mirroring of its
22 interstate switched access rates and the non-basic service rate increases
23 as originally proposed; and (iii) Buffalo Valley reduced its annual Chapter
24 30 revenue entitlement by \$14,925 from \$328,482 to \$313,557. Buffalo

1 Valley reduced its proposed CC increase from \$0.97 per line to \$0.91 per
2 line and retained the mirroring of its interstate switched access rates and
3 the basic and non-basic service rate increases as originally proposed in its
4 2006 Filing.

5 **Q. Did the PaPUC subsequently revise the procedure to address the**
6 **D&E carrier's election to increase their intrastate access charges in**
7 **lieu of banking or placing the increases on basic exchange rates?**

8 A. Yes, by Order entered November 15, 2006 ("November 15 Order"), the
9 PaPUC bifurcated the questions concerning the D&E carriers' June 28
10 Compliance Filings from Docket No. I-00040105 and assigned the
11 bifurcated proceeding to the Office of Administrative Law Judge for
12 recommended decision on an expedited basis.

13 **Q. Are you authorized to appear and testify on behalf of the D&E**
14 **carriers in this bifurcated proceeding which has been assigned to**
15 **Administrative Law Judge ("ALJ") Susan D. Colwell?**

16 A. Yes, I am authorized to appear and testify on behalf of the D&E carriers.

17 **Purpose**

18 **Q. What is the purpose of your testimony in this bifurcated proceeding?**

19 A. The purpose of my testimony is to address the issues raised in the
20 November 15 Order relative to the PaPUC's June 23 Orders. Specifically,
21 the PaPUC directed this proceeding to consider whether the intrastate
22 access charge increases filed by the D&E carriers on June 28, 2006, are
23 consistent with the PaPUC's access service reform policy as enunciated in
24 the Global Order entered September 30, 1999, at Docket Nos.

1 P-00991648 and P-00991649, the regulations and policies governing the
2 Pennsylvania Universal Service Fund ("PaUSF"), the Rural Telephone
3 Company Coalition's ("RTCC")¹ request for stay of the PaPUC's pending
4 investigation at Docket No. I-00040105, the D&E carriers' Amended
5 Chapter 30 Plans and their applicable statutory obligations under Chapter
6 30 of the Public Utility Code. ALJ Colwell, in her subsequent Scheduling
7 Order, at page 15, more concisely summarized these issues as follows:
8 "The Order directs that the goal is to determine, based on the record,
9 whether any rescission or amendment [in the June 28 Compliance Filings]
10 would be warranted by the evidence, consistent with our access charge
11 reform and universal service policies, and lawful under the Companies'
12 Chapter 30 plans."

13 For the purpose of my direct testimony, I will divide this statement
14 into specific segments. I will address both PaPUC access charge reform
15 and universal service policy as set forth in prior PaPUC orders and show
16 there is no prohibition precluding the intrastate access charge changes in

¹The RTCC comprises the following rural incumbent local exchange carriers: Windstream Pennsylvania, Inc., f/k/a ALLTEL Pennsylvania, Inc., Armstrong Telephone Company - PA, Armstrong Telephone Company-North, Bentleyville Communications Corporation, d/b/a The Bentleyville Telephone Company, Buffalo Valley Telephone Company, Citizens Telephone Company of Kecksburg, Commonwealth Telephone Company, Conestoga Telephone and Telegraph Company, Denver and Ephrata Telephone and Telegraph Company, Deposit Telephone Company, Frontier Communications of Breezewood, Inc., Frontier Communications of Canton, Inc., Frontier Communications of Lakewood, Inc., Frontier Communications of Oswayo River, Inc., Frontier Communications of Pennsylvania, Inc., The Hancock Telephone Company, Hickory Telephone Company, Ironton Telephone Company, Lackawaxen Telecommunications Services, Inc., Laurel Highland Telephone Company, Mahanoy & Mahantango Telephone Co., Marianna & Scenery Hill Telephone Company, The North-Eastern Pennsylvania Telephone Company, North Penn Telephone Company, North Pittsburgh Telephone Company, Palmerton Telephone Company, Pennsylvania Telephone Company, Pymatuning Independent Telephone Company, South Canaan Telephone Company, Sugar Valley Telephone Company, Venus Telephone Corporation, West Side Telephone Company and Yukon-Waltz Telephone Company.

1 this proceeding. I will next address Chapter 30, Act 183, and the D&E
2 carriers' Chapter 30 Plans and show that the June 28 Compliance Filings
3 are consistent therewith. Finally, I will address cost issues.

4 **Q. Are the D&E carriers fulfilling their obligations under their Chapter 30**
5 **Plans?**

6 A. Yes, the D&E carriers are fast at work to bring universal broadband
7 availability to their rural service territories by December 31, 2008. The
8 D&E carriers, in good faith, sought to utilize their effective Chapter 30
9 Plans to provide additional annual revenues to assist in providing funds
10 necessary to provide service to new developments within our certificated
11 service areas in accordance with our carrier of last resort obligations, to
12 provide improvements in our networks to meet the service quality
13 requirements our customers expect and that are required of us by PaPUC
14 regulations and to assist in carrying out this network modernization to
15 bring universal broadband availability to our rural customers by December
16 31, 2008. As shown herein, there have been no PaPUC orders freezing
17 intrastate access charge increases or any orders or Chapter 30 plan
18 provisions prohibiting such increases. Moreover, we thoroughly reviewed
19 Act 183 and also found no such prohibition. D&E did not desire to
20 implement these small changes in carriers' intrastate access charges.
21 However, our basic local exchange rates have been increased
22 significantly in recent years and with the further \$0.30 increase in the
23 Buffalo Valley basic exchange rates, we deemed from a competitive
24 standpoint further basic exchange rate increases were not feasible at this

1 time. I will show that the D&E carriers have been frontrunners in the rural
2 ILEC industry in implementing voluntary access charge reductions. Even
3 after the June 28 Compliance Filings' rate changes, our CC rates remain
4 below the \$7.00 Global benchmark rate and our switched intrastate
5 access rates in total remain below the level established in the Global
6 Order and, consistent with PaPUC access charge reform precedent,
7 mirror interstate rates, thereby avoiding arbitrage.

8 **PaPUC Orders – Global and Access Charge Investigation per Global Order**
9 **of September 30, 1999 (“2003 Joint Stipulation Order”)**

10 **Q. The November 15 Order entertains an extensive discussion of the**
11 **PaPUC's Global proceeding. Did you participate in the Global**
12 **proceeding?**

13 **A.** Yes, I was extensively involved in the Global proceeding. I was actively
14 involved on behalf of all rural ILECs in the development of the rural
15 carriers' compliance schedules, having the responsibility to collect, review
16 and correct if necessary the data. I was responsible for developing all of
17 the worksheets that calculated existing interstate and intrastate traffic
18 sensitive switched access rates and the impact to mirror interstate rates,
19 the worksheets that calculated the impact to bring intrastate carrier
20 common line revenues down to the agreed to benchmark of \$7.00 per line,
21 the worksheets to calculate the impacts to reduce intralata toll rates,
22 increase or decrease local service rates, savings in the ITORP settlement
23 process due to reduced intrastate access rates, establishment of a PaUSF
24 and the amounts required as a result of all of the changes above plus the

1 additional amounts of PaUSF required by rural carriers to recover their
2 new PaUSF assessments so that the impacts of this revenue and rate
3 rebalancing were neutral to the rural carriers.

4 **Q. Please describe what you mean by “mirror interstate rates” and**
5 **explain where the term originated and if the term is used outside of**
6 **the Global proceeding.**

7 A. To “mirror interstate rates” means to bring intrastate rates into parity with
8 interstate rates, or in other words, adopt the interstate rates as intrastate
9 rates for intrastate purposes. The phrase was adopted in the Global
10 proceeding and has been used ever since.

11 **Q. Please briefly describe the Global proceeding from the standpoint of**
12 **the D&E carriers.**

13 A. Given the enormously complex issues facing the telecommunications
14 industry in the 1990's as a result of many technology and regulatory
15 changes, the 1993 enactment of Chapter 30, implementation of the
16 Telecommunications Act of 1996, and the introduction of competition into
17 what had historically been a monopoly environment, the PaPUC invited
18 interested parties to participate in “Global Settlement Talks”. While these
19 discussions, held in late 1998 and early 1999, focused on many issues, no
20 comprehensive settlement was achieved and the negotiations were
21 terminated.

22 **Q. Were separate petitions filed by various parties to the negotiations**
23 **on March 18, 1999?**

1 Yes. On March 18, 1999, two separate petitions were filed with the
2 PaPUC, each proposing a comprehensive global resolution of the various
3 issues.² The two petitions were consolidated and litigation commenced.
4 Hearings were subsequently held and the Global Order was entered on
5 September 30, 1999, resolving the proceeding. The Global petitions
6 addressed a host of issues (most of the issues were specific to Bell
7 Atlantic but certain issues were specific to the rural ILECs). The primary
8 issues addressing the rural ILECs included revenue neutral local, toll and
9 access rate rebalancing, and universal service funding resulting from such
10 rate rebalancing. For the most part, the Global Order adopted the
11 revenue neutral rate rebalancing and universal service funding proposal
12 sponsored by Bell Atlantic (now "Verizon") and the rural ILECs in the
13 petition at Docket No. P-00991649.

14 The PaPUC's November 15 Order in this bifurcated proceeding, at
15 6-7, correctly summarizes the rural ILEC rate changes and universal
16 service funding associated therewith as follows:

17 The components of the PaUSF, from the standpoint of
18 the RTCC members, are briefly summarized below:
19

20 1. All small incumbent local exchange carriers,
21 which included all ILECs other than Bell and GTE North
22 (GTE North is now Verizon North), were directed to be
23 recipients of the PaUSF. The PaUSF was established for

²The Petition at P-00991648 was filed by Nextlink Pennsylvania, Inc., Pennsylvania State Senators Vincent J. Fumo, Roger A. Madigan, and Mary Jo White, MCI WorldCom ("MCIW"), the Pennsylvania Cable & Television Association, RCN Telecommunications Services of Pennsylvania, Inc., Hyperion Telecommunications, Inc., ATX Telecommunications, CTSI, Inc., and AT&T Communications of Pennsylvania, Inc.. The Petition at P-00991649 was filed by Bell Atlantic-Pennsylvania, Inc. (now "Verizon"), Conectiv Communications, Inc., Network Access Solutions, and The Rural Telephone Company Coalition.

1 the purpose of the rate rebalancing needs of the rural local
2 exchange carriers including reductions in their intrastate
3 access and toll rates. All Pennsylvania telecommunications
4 service providers (excluding wireless carriers) were directed
5 to contribute to the PaUSF based upon their intrastate end-
6 user revenues.
7

8 2. The RTCC members were permitted to
9 restructure, modify and reduce their access, toll and local
10 rates, as follows:
11

12 a) Intrastate traffic sensitive switched
13 access rates and structure (including local transport
14 restructure) were converted to mirror interstate
15 switched access rates and structure in effect on
16 July 1, 1998.
17

18 b) The Common Carrier Line Charge
19 ("CCLC") was restructured as a flat-rate Carrier
20 Charge ("CC") and reduced to an intrastate rate not
21 exceeding \$7.00 per line and allocated to intrastate
22 toll providers based on their relative minutes of use.
23

24 c) The RTCC members were given the
25 opportunity to reduce their intrastate toll rates to an
26 average rate not lower than \$.09 per minute.
27

28 d) The RTCC members with low local
29 exchange rates were permitted to increase their
30 residential one-party basic, local rates to an average
31 monthly charge of at least \$10.83, to the extent
32 necessary to offset the reduced toll rates.
33

34 (e) Those RTCC members with an average
35 monthly R-1 rate above \$16.00 (inclusive of touch-
36 tone) were directed to provide their customers with a
37 Universal Service credit to effectively reduce the rate
38 to \$16.00 with the difference coming out of the
39 PaUSF.
40

41 Following the entry of the Global Order, the PaPUC entertained a
42 rulemaking proceeding which resulted in regulations at 52 Pa. Code
43 §63.161 et seq. establishing the PaUSF consistent with the revenue
44 neutral rate rebalancing requirements of the Global Order.

- 1 **Q. What role did the PaUSF play to maintain revenue neutrality?**
- 2 A. As stated in the Global Order at 142, the PaUSF was the "means to
3 reduce access rates and toll rates for the ultimate benefit of the end-user
4 and to encourage greater toll competition, while enabling carriers to
5 continue to preserve the affordability of local service rates." Although
6 referred to as a "fund," the Global Order went on to explain "it is actually a
7 pass-through mechanism to facilitate transition from a monopoly
8 environment to a competitive environment – an exchange of revenue
9 between telephone companies which attempts to equalize mandated
10 decreases in [rural ILEC] toll and access charges." Thus, the PaUSF
11 simply maintained revenue neutrality for the rural ILECs to achieve the
12 Global Order mandated rate rebalancings. The PaUSF was also
13 premised on the State and Federal policy of fostering universal service to
14 assure that ubiquitous and affordable local service remained available to
15 all customers.
- 16 **Q. Again, what were the benchmarks that the PaPUC established in its**
17 **Global Order for rural ILEC intrastate access charges?**
- 18 A. The benchmark rates for access services were set at \$7.00 per access
19 line per month for the CC and the mirroring of intrastate and interstate
20 switched access rates.
- 21 **Q. Is this mirroring of intrastate and interstate switched access rates**
22 **what was meant in the Global Order at page 51 when it directed, "The**
23 **rate restructuring tariffs the affected companies must file should**

1 include changes to their intrastate access charges to match their
2 federal tariffs....”

3 A. Yes.

4 **Q. Why is it important to mirror intrastate and interstate traffic sensitive**
5 **rates?**

6 A. It is important to maintain intrastate and interstate access rates at or near
7 parity because it is an important step towards eliminating jurisdictional
8 arbitrage. In addition, since the D&E carriers' interstate access rates are
9 designed by NECA and approved by the FCC based on costs in
10 accordance with FCC rules and regulations, it ensures that the intrastate
11 access rates are compensatory rates.

12 **Q. Please explain what you mean by “jurisdictional arbitrage” and**
13 **“compensatory rates.”**

14 A. Jurisdictional arbitrage is the misidentification of traffic by jurisdiction by
15 carriers in order to be billed the lowest access charges. Compensatory
16 rates are rates that ensure the company recovers its cost of providing
17 services and earns a reasonable return on its investment.

18 **Q. Would it be accurate to say that most of the rural carriers, but not the**
19 **D&E carriers, have increased their CC above the \$7.00 Global**
20 **benchmark?**

21 A. Yes, as shown in D&E Exhibit 1. It must be recognized that beginning
22 with the Global Order, the PaPUC has consistently taken action to permit
23 the mirroring of intrastate and interstate traffic sensitive access rates to
24 avoid arbitrage. Further, in the 2003 Joint Stipulation Order, the PaPUC

1 permitted rural ILECs' CC rates to exceed the \$7.00 Global benchmark
2 rate. Also, the PaPUC has consistently recognized that rural ILECs' local
3 exchange rates must remain affordable and be set at competitive levels.

4 **Q. Please describe the USF support received by the D&E carriers from**
5 **the rate reform adopted by the Global Order.**

6 A. D&E Exhibit 2 identifies the amount of PaUSF receipts and estimated
7 amount of PaUSF assessment included in the receipts. This exhibit
8 shows that the amount of support D&E Telephone was to receive as a
9 result of the Global proceeding calculations was only an amount equal to
10 what was estimated that D&E Telephone would be required to pay into the
11 PaUSF. In other words, D&E Telephone received no support dollars for
12 changes in intrastate rates as a result of the Global proceeding. While the
13 amount due D&E Telephone has not changed over time, the assessment
14 amount owed by D&E Telephone to the PaUSF has increased, making
15 D&E Telephone a net payer into the fund today.

16 **Q. Were cost studies required to be filed to support the access rates**
17 **established in the Global Order?**

18 A. No cost studies to my knowledge were filed in the Global proceeding by
19 any rural exchange carrier identifying their cost of each switched access
20 rate element. The D&E carriers are also unaware of any PaPUC cost
21 allocation rule or cost modeling program applicable to rural ILECs that
22 specifically identified how costs should be calculated for each and every
23 intrastate access tariff rate element. However, the PaPUC did accept in
24 the Global Order the use of interstate traffic sensitive switched access

1 cost based rates as appropriate rates for intrastate purposes since access
2 costs on an individual company basis should be the same regardless of
3 jurisdiction and thus the prices should be the same. The PaPUC also
4 adopted the cap of \$7.00 as a reasonable rate for the CC in conjunction
5 with reductions in toll service rates, changes in local service rates and the
6 establishment of a state Universal Service Fund.

7 **Q. Did the Global Order expressly prohibit rural ILECs from**
8 **subsequently increasing the \$7.00 CC benchmark rate or increasing**
9 **their intrastate switched access charges to maintain mirroring of**
10 **federal traffic sensitive rates?**

11 A. No, there was no such prohibition in the Global Order stating that access
12 rates were frozen.

13 **Q. On page 3 of the November 15 Order, the PaPUC refers to the joint**
14 **stipulation filed by the RTCC members, Verizon and others on June**
15 **5, 2003. Please describe this joint stipulation.**

16 A. The Global Order called for an investigation to be initiated in 2001 to
17 revisit the carrier charge pool and universal service. By Secretarial Letter
18 dated October 24, 2001, the PaPUC postponed a formal investigation and
19 initiated a collaborative to determine whether the parties could reach
20 agreement. In June 2002, the PaPUC opened a Docket at M-00021596,
21 et al., to address this investigation/collaborative. On December 16, 2002,
22 RTCC, Sprint/United, OCA, OTS and OSBA filed a joint proposal seeking
23 further revenue-neutral access charge reductions with a continuation of

1 the PaUSF. Verizon subsequently submitted a letter on April 3, 2003 that
2 it did not oppose the joint proposal.

3 The joint proposal provided in pertinent part that a rural ILEC could
4 lower its intrastate traffic sensitive rates to move closer or mirror its
5 interstate rates and increase its CC by a corresponding revenue-neutral
6 amount in 2003 and in 2004. In other words, the Global Order's \$7.00
7 benchmark CC could be increased. Each rural ILEC was to increase its
8 R-1 rates by December 31, 2003, to achieve revenue-neutrality, but not to
9 a monthly average rate greater than \$18.00. If, however, a rural ILEC's
10 average R-1 rate exceeded the \$18.00 cap, as a result of the rebalancing,
11 it was required to cap it at \$18.00 and recover the shortfall from the
12 PaUSF. The joint proposal also provided that smaller rural ILECs (less
13 than 20,000 access lines) would receive an additional \$2.00/month/line
14 from PaUSF funds formerly paid to Sprint and the smaller rural ILECs
15 would further reduce their CC or traffic sensitive rates by a revenue-
16 neutral amount to offset the additional \$2.00/month/line from the PaUSF.
17 As stated, Verizon did not oppose such changes including the increases to
18 the CC rates and the mirroring of intrastate and interstate access charges.
19 Also, as recognized in the November 15 Order, at 3, these rate changes
20 did not result in any change in the total PaUSF.

21 Subsequently, a Joint Procedural Stipulation signed by all parties
22 was filed with the PaPUC. By Order entered July 15, 2003, at Docket
23 Nos. M-00021596 et al., Access Charge Investigation per Global Order of
24 September 30, 1999 ("2003 Joint Stipulation Order"), the PaPUC

1 approved the Joint Procedural Stipulation and held that the PaUSF should
2 continue under the existing regulations until modified by a further
3 rulemaking. The 2003 Joint Stipulation Order, at 11, specifically noted
4 that while mirroring of interstate access charges was not mandated, it did
5 assist in avoiding arbitrage: "While the Joint Proposal does not require a
6 rural ILEC or Sprint/United to mirror interstate access charges, the fact
7 that this is a step towards making the charges closer to cost and closer to
8 the interstate access charges will help to avoid arbitrage and will help
9 competition enter the ILEC's territories."

10 **Q. As a result of this 2003 Joint Stipulation Order, did the D&E carriers**
11 **receive additional PaUSF support amounts?**

12 A. No, the D&E carriers did not receive any additional PaUSF support
13 amounts as a result of the 2003 Joint Stipulation Order. Only smaller rural
14 exchange carriers received additional PaUSF support.

15 **Q. Did this 2003 Joint Stipulation Order have any impact on the D&E**
16 **carriers' intrastate access rates?**

17 A. The 2003 Joint Stipulation Order permitted rural carriers to lower their
18 intrastate traffic sensitive rates to match or move closer to their interstate
19 traffic sensitive rates, and simultaneously increase their CC by a
20 corresponding revenue neutral amount. Since the D&E carriers'
21 intrastate traffic sensitive switched access rates at the time of the Order
22 were already below their existing interstate rates, no changes were made
23 to intrastate traffic sensitive switched access rates. Since D&E Telephone
24 and Conestoga had voluntarily rate rebalanced earlier in 2003 raising local

1 rates and reducing the CC, no further filing was required of either
2 Company. Buffalo Valley had also voluntarily rate rebalanced earlier in
3 2003, but made a further filing pursuant to the Joint Stipulation to further
4 raise local rates and reduce the CC.

5 Q. **As a result of the 2003 Joint Stipulation Order what was the final**
6 **impact on other rural carriers' CC rates?**

7 A. As stated above, the 2003 Joint Stipulation Order permitted all rural
8 carriers to lower their intrastate traffic sensitive rates to match or move
9 closer to their interstate traffic sensitive rates, and simultaneously increase
10 their CC by a corresponding revenue neutral amount. This allowed
11 carriers to increase their CC rates well above the initial \$7.00 benchmark
12 established in the Global Order. Thus, while the Global Order had
13 established a cap of no more than \$7.00 for the CC, with instructions to
14 review the rates and investigate whether this rate could be reduced, the
15 PaPUC in this 2003 Joint Stipulation Order allowed increases to the CC.
16 Today some carriers still have intrastate CC rates ranging from over ten
17 dollars per line to a high of seventeen dollars and ninety-nine cents per
18 line.

19 Q. **Did the PaPUC, in approving the Joint Stipulation, review rural ILEC**
20 **cost studies to support the changes in intrastate access rates and in**
21 **particular the increases in the CC?**

22 A. No, the PaPUC continued its position adopted in the Global Order
23 accepting the interstate traffic sensitive switched access cost based rates
24 as appropriate rates for intrastate purposes. However, the Joint

1 Stipulation approved by the PaPUC allowed increases in the intrastate
2 carrier charge, some of them extremely large increases, on a revenue
3 neutral basis without, to the best of my knowledge, any cost support for
4 those rate changes. The PaPUC then accepted these new carrier charge
5 rates as reasonable.

6 **Q. Did the 2003 Joint Stipulation Order freeze access rates, the PaUSF**
7 **or the application of Chapter 30 Plans from the standpoint of**
8 **protected services including intrastate access?**

9 A. No, there was no express provision in the Order stating that access rates
10 were frozen. Based thereon, the D&E carriers retained the right under
11 their Chapter 30 Plans to adjust their intrastate access charges as long as
12 they remained consistent with the Global Order and consistent with their
13 plans. More specifically, it was our understanding that we retained the
14 right and flexibility in accordance with our Chapter 30 Plans to change all
15 noncompetitive rates, subject to the terms of our PSI/SPI. This allowed us
16 to *increase our CC rates* as long as we remained below the rates
17 established in the Global Order and allowed us to continue prior PaPUC
18 approved orders that provided for mirroring of our interstate rates to avoid
19 arbitrage.

20 **Q. Did the PaPUC initiate a further investigation of access and toll rates**
21 **of rural ILECs and the PaUSF in 2004?**

22 A. Yes, as recognized on page 3 of the November 15 Order, the PaPUC
23 initiated a statewide proceeding, at Docket No. I-00040105, by Order
24 entered December 20, 2004.

1 **Q. What is the scope of PaPUC's investigation at Docket No. I-**
2 **00040105?**

3 A. The scope of the investigation is to consider "whether there should be
4 further intrastate access charge reductions and IntraLATA toll rate
5 reductions in the service territories of rural ILECs and all rate issues and
6 rate changes that should or would result in the event that disbursements
7 from the Pennsylvania Universal Service Fund are reduced."
8 December 20, 2004 Order at 1. The PaPUC in this Order did not
9 expressly prohibit rural ILECs from, in the interim, changing their intrastate
10 rates. Further, the Pa PUC did not prohibit those rural ILECs with CCs
11 below the Global benchmark from increasing their CCs through the
12 Chapter 30 process to levels still below the \$7.00 benchmark and to
13 continue to mirror interstate switched rates.

14 **Q. What is the status of this investigation?**

15 A. On May 23, 2005, a joint motion to defer the investigation pending
16 resolution of the FCC intercarrier compensation proceeding at CC Docket
17 No. 01-92 was filed by RTCC, OCA, and OTS. The joint motion explained
18 that the pending FCC intercarrier compensation proceeding would impact
19 and possibly preempt state action or reform. In particular it was pointed
20 out that aggressive action on Pennsylvania's part further decreasing
21 access rates could actually prejudice the Pennsylvania rural ILECs and
22 their consumers and stated "Pennsylvania consumers and carriers could
23 lose the opportunity to benefit fully from increased federal funding simply
24 because they may have moved too quickly in reducing their access rates

1 before new federal mechanisms were put in place." By Order entered
2 August 30, 2005, at Docket No. I-00040105, the PaPUC granted the joint
3 motion and stayed the investigation for a period of 12 months: In its
4 August 30 Order, at 16-17, the PaPUC held:

5 In its Brief, the OCA clearly and persuasively
6 demonstrates the risks to the end-user ratepayers of the
7 rural ILECs if this investigation were allowed to proceed
8 while the FCC's Unified Intercarrier Compensation
9 proceeding was still pending. For example, the OCA points
10 out that, depending on the outcome of the FCC's Unified
11 Intercarrier Compensation proceeding, if this Commission
12 proceeds with intrastate access charge reform, potentially
13 increased federal USF funding may not apply to rural ILEC
14 intrastate access charge reductions that will be put in place
15 prior to the conclusion of the FCC's proceeding. (OCA Brief
16 at 8-9). Similarly, the OCA persuasively argues that, under
17 certain outcomes in the same FCC proceeding, the rural
18 ILECs' ratepayers may bear the same burden twice from the
19 same reduction in intrastate access charges if such
20 reductions are not simultaneously coordinated between this
21 Commission and the FCC. (OCA Brief at 9-10). In short, the
22 interests of the rural ILEC ratepayers will be seriously
23 prejudiced if this investigation is not coordinated with the
24 ongoing FCC Unified Intercarrier Compensation proceeding.
25 Such prejudice meets the applicable legal standards of
26 granting the stay of the investigation in accordance with the
27 request of Joint Petitioners and, in our opinion, outweighs
28 the potential benefits that could be achieved through a more
29 immediate implementation of intrastate carrier access
30 charge reform for the rural ILECs through this investigation.

31
32 At the end of the 12 months the PaPUC at 18 noted that the resumed
33 investigation:

34 ... should include and provide record evidence
35 addressing the legal, ratemaking, and regulatory accounting
36 linkages between: (1) the FCC's ruling in its Unified
37 Intercarrier Compensation proceeding; (2) the intrastate
38 access charge reform for rural ILECs in view of the new
39 Chapter 30 law and its relevant provisions at 66 Pa. C.S. §§
40 3015 and 3017; (3) the Pa. USF; and (4) the potential rate
41 effects on the basic local exchange services of the rural
42 ILECs.

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Q. Did this August 30, 2005 Order freeze access rates, the PaUSF or the application of Chapter 30 plans from the standpoint of protected services including intrastate access during the pendency of the stay?

A. Again the answer is no. While the PaPUC's Order stayed the investigation, there was no express provision in the Order stating that access rates were frozen during the pendency of the stay. Based thereon, the D&E carriers retained the right under their Amended Chapter 30 Plans to adjust their intrastate access charges as long as they remained consistent with the Global Order and consistent with their plans. More specifically, it was our understanding that we retained the right and flexibility in accordance with our Chapter 30 Plans to change all noncompetitive rates, subject to the terms of our PSI/SPI. This allowed us to increase our CC rates as long as we continued to remain below the rates established in the Global Order and allowed us to continue prior PaPUC approved orders that provided for mirroring of our interstate rates to avoid arbitrage.

Q. Subsequent to the August 30, 2005 Order, did the PaPUC enter any other order regarding further review of access rates and the PaUSF?

A. Pursuant to the aforesaid August 30, 2005 Order at Docket No. I-00040105, a Joint Status Report was filed by RTCC, OTS, OCA and Embarq on August 30, 2006, as well as a Joint Motion for Further Stay of the investigation recognizing the possible impact of the FCC intercarrier compensation proceeding and in particular the submission to the FCC on

1 July 18, 2006 of the Missoula Plan developed by the stakeholders of the
2 NARUC Task Force. The PaPUC granted the Joint Motion by Order
3 entered November 18, 2006.

4 **Q. What did the November 18, 2006 Order stay?**

5 A. The November 18, 2006 Order further stayed the state-wide investigation
6 at Docket No. I-00040105.

7 **Q. Did this Order expressly provide that access rates for rural ILECs**
8 **were to be frozen, or that rural ILECs were required to amend their**
9 **Chapter 30 Plans or adjust future Chapter 30 filings to prohibit**
10 **intrastate access rate increases or the mirroring of interstate access**
11 **charges?**

12 A. Again the answer is no. The PaPUC did not state anywhere in this Order
13 that it was implementing a freeze of intrastate rural ILEC access rates nor
14 did the PaPUC state anywhere in the Order that it was altering or
15 changing any rural ILECs Amended Chapter 30 Plans to preclude access
16 charge changes. Based thereon, the D&E carriers retained the right under
17 their Amended Chapter 30 Plans to adjust their intrastate access charges
18 as long as they remained consistent with the Global Order and consistent
19 with their plans. More specifically, it was our understanding that we
20 retained the right and flexibility in accordance with our Chapter 30 Plans to
21 change all noncompetitive rates, subject to the terms of our PSI/SPI. This
22 allowed us to increase our CC rates as long as we continued to remain
23 below the rates established in the Global Order and allowed us to continue

1 prior PaPUC approved orders that provided for mirroring of our interstate
2 rates to avoid arbitrage.

3 **Q. In light of this historical background, what is the D&E carriers'**
4 **position regarding the statement in the November 15 Order, at 14,**
5 **that, "The fact we never expressly stated that increases to access**
6 **charges were precluded until the next investigation was held, does**
7 **not mean the PaPUC intended to carve out an exception to our**
8 **general public policy rule of lowering intrastate access charges and**
9 **allow for intermittent increases to intrastate access charges with**
10 **rural ILEC PSI filings."**

11 A. I totally agree that the PaPUC never expressly prohibited further increases
12 to intrastate access charges. In my opinion, if the PaPUC intended to
13 have a general public policy rule of only allowing intrastate access rates to
14 decrease, they could have removed those services from the carriers list of
15 noncompetitive services and from the carriers PSI/SPI calculations. The
16 Global Order established caps on rates and the CC rates were later
17 allowed to increase in the 2003 Joint Stipulation Order. Furthermore, the
18 2003 Joint Stipulation Order expressly allowed for increases in access
19 rates to ensure that they at least recovered its costs and the ILECs SPI
20 continues to be equal or less than the PSI. Carriers retained their rights to
21 implement all rate rebalancing and rate filings permitted under their
22 Chapter 30 Plans. Based thereon, the D&E carriers in good faith believed,
23 after they committed to accelerate their 100% broadband commitments
24 under Act 183, that they had the right to adjust their intrastate switched

1 access rates to continue mirroring interstate rates. Further, in light of the
2 Global Order and 2003 Joint Stipulation Order which continued the policy
3 of mirroring interstate traffic sensitive switched access rates and increased
4 the intrastate carrier charge rate, the D&E carriers sincerely believed that
5 they had the right to adjust their CC rates upward provided they remained
6 in compliance with their effective Chapter 30 Plans and did not exceed the
7 Global benchmark. The D&E carriers firmly recognize that it has been the
8 objective of this PaPUC to reduce intrastate access charges. The
9 evidence in D&E Exhibits 1, 3 and 4 clearly affirms that notwithstanding
10 the 2006 Filings, the D&E carriers have been frontrunners in meeting this
11 objective while other rural carriers have not been. It is imperative to note
12 that the D&E carriers were not required to make reductions to their
13 intrastate access rates following the Global proceeding and if they had
14 taken that approach which the PaPUC has allowed many rural carriers to
15 take, then the intrastate access rates of the D&E carriers would be far
16 greater than what is reflected in the June 28 Compliance Filings. In fact, if
17 it had been an express public policy statement of the PaPUC that access
18 rates could only decrease after the Global Order, the D&E carriers may
19 very well not have taken such an aggressive position in reducing access
20 rates voluntarily. Because of the filings made since the Global Order, long
21 distance providers have enjoyed access expense reductions that they
22 would not have received if it were not for the voluntary actions of the D&E
23 carriers. To deny the small increases now in question, which amount only
24 to a partial offset to those prior voluntary access reductions and which are

1 supported by interstate rates for the same network elements allowing the
2 D&E carriers to meet their advanced network commitments which were
3 not made by Verizon, is not in the public interest.

4 **Chapter 30 and Initial Chapter 30 Plans**

5 **Q. Please describe the D&E carriers' initial plans under the Chapter 30**
6 **law enacted in 1993.**

7 A. The D&E carriers elected to be regulated under alternative regulation as
8 enacted in the original Chapter 30 law, 66 Pa.C.S. §§3001-3009. All
9 three carriers participated as a part of the Pennsylvania Telephone
10 Association Small Company Group ("PTA SCG") in a group filing made on
11 July 31, 1998. The nineteen small, rural telephone companies that
12 comprised the PTA SCG joined together for the purpose of seeking
13 approval of a uniform Chapter 30 Alternative and Streamlined Regulation
14 Plan together with company-specific Network Modernization Plans. The
15 SCG companies did not merely replicate a Chapter 30 plan previously
16 approved by the PaPUC, but instead developed a plan designed to
17 address their specific circumstances. In return for being provided an
18 alternative form of regulation, these rural ILECs assumed the costly but
19 absolute commitment to make broadband universally available throughout
20 their rural service territories by 2015 regardless of demand. For example,
21 the D&E carriers proposed networks providing for the deployment of
22 universally available high-speed broadband capacity by December 31,
23 2015, offering greater and more varied services to customers, with the
24 objective of contributing significantly to economic development within their

1 rural service territories, which areas, but for such deployment, may not
2 have benefited so quickly from advanced telecommunications technology.

3 *After several months of mediation and litigation, the PaPUC issued*
4 *a final Order on December 22, 2000, approving the PTA SCG proposed*
5 *Chapter 30 Plans with various modifications. Thirty days thereafter, the*
6 *D&E carriers on January 22, 2001, filed their effective initial Chapter 30*
7 *Plans. A final compliance order was entered on July 30, 2001, almost*
8 *three years to the day of their initial filing.*

9 **Q. What were the pertinent provisions of the plans, particularly as they**
10 **relate to the D&E carriers' ability to raise rates and concomitantly**
11 **deploy the broadband networks required under Chapter 30?**

12 A. The plans essentially have four operative parts:³ The Network
13 Modernization Plan ("NMP"); the Competitive Services Deregulation Plan;
14 the Price Stability Plan for Noncompetitive Services ("PSP"); and a catch-
15 all provision for Additional Commitments and Other Terms. Of these
16 provisions, the NMP and PSP, which address respectively the carriers'
17 obligations to modernize their networks and the means by which they may
18 annually raise revenues, are most pertinent to the issues raised in this
19 bifurcated proceeding.

20 **Q. Please describe the D&E carriers' Price Stability Plan.**

³Since most of the relevant provisions of the initial Plans remain in effect, I, for the most part, will refer to the provisions of the Plans in the present tense.

1 A. The PSP sets out the formula, principles and procedures that govern how
2 the carriers' rates are subject to change and is contained in Part 3 of the
3 plans. For discussion purposes, I will cite to pertinent pages of the D&E
4 Telephone Chapter 30 Plan, however, for purposes of the PSP, the D&E
5 carriers' plans are identical.

6 The PSP replaced the principles and procedures under Chapter 13
7 of the Public Utility Code previously governing rate changes.⁴ In other
8 words, as set forth elsewhere in the D&E carriers' plans, the PSP and the
9 Price Stability Mechanism ("PSM") contained therein were a substitute for
10 traditional rate base/rate of return regulation, and form "the exclusive
11 basis" upon which the D&E carriers' noncompetitive rates are regulated.⁵

12 **Q. Would you please describe the PSM?**

13 A. The PSM is the part of the overall PSP that sets forth the manner for rate
14 changes for all noncompetitive services. The PSM is based upon the
15 rates in effect on the approval date of the plan[s] or as otherwise adjusted
16 pursuant to the Global Order, which rates were deemed "just, reasonable,
17 nondiscriminatory and otherwise fully in compliance with all Pennsylvania
18 laws."⁶ Under the PSM formula, the D&E carriers' use the annual PSI to
19 reflect the annual change in the GDPPI, including the additional impact of

⁴E.g., Part 3 - Price Stability Plan For Noncompetitive Services, page 7 of the D&E Telephone initial Chapter 30 Plan.

⁵See D&E Telephone initial Chapter 30 Plan at page 8, Part 3.A.3.

⁶See D&E Telephone initial Chapter 30 Plan at page 7, Part 3.A.1.

1 exogenous events. Initially, a 2% offset to the PSI formula was applied in
2 determining the allowable annual change in intrastate noncompetitive
3 service revenues. Once an allowed revenue change is determined, that
4 revenue increase is allocated at the carriers' discretion among
5 noncompetitive rates.

6 The Chapter 30 Plans called for the filing of the initial PSI and SPI
7 Reports on or before the anniversary date of the plan and annually
8 thereafter. Since the plans were filed January 22, 2001, the D&E carriers'
9 initial PSI filings would have been due on or before January 22, 2002.
10 The D&E carriers requested and were granted an extension for filing their
11 plans, and have thereafter filed annual PSI/SPI filings on or before April 30
12 of each year, unless a further extension was granted.

13 **Q. Would you please describe more specifically how the PSM works?**

14 A. The plans contain a detailed formula, represented as follows:

$$15 \quad \text{PSI}_t = \text{PSI}_{t-1} (1 + \% \Delta \text{GDP-PI} - X \pm Z)$$

16 In narrative, this means the new PSI index (PSI_t), which determines the
17 allowable annual revenue change for the applicable period, equals the
18 current index (PSI_{t-1}) multiplied by the percentage change in the GDPPI
19 over the past year minus a 2% inflation offset (the "X" factor) plus any
20 effect of exogenous events ("Z").

21 Each quarter the United States Department of Commerce publishes
22 changes to the GDPPI. The carriers choose a GDPPI quarterly report that
23 ends not more than 8 months prior to the advance notice date of the
24 annual PSI, and compare that to the corresponding quarter of the previous

1 period. This provides the carriers the percentage change in the applicable
2 annual GDPPI period, or the "% Δ GDP-PI" of the above formula. This
3 percentage change is then multiplied against the carriers' total intrastate
4 noncompetitive revenues to determine the allowable annual revenue
5 change.

6 Any increases the D&E carriers elect not to implement may be
7 banked for a period of 4 consecutive years, but the carriers lose any
8 allowable banked increases not implemented within the 4 years, and also
9 lose any carrying costs or interest as a result of deferring the increase. In
10 other words, there is no compounding effect during the deferral period,
11 and revenues lost from the time new rates could have been implemented
12 are lost forever.

13 It is pursuant to this formula that all allowable changes in rates for
14 noncompetitive services were initially determined under the D&E carriers'
15 Chapter 30 Plans.

16 **Q. Under the D&E carriers' Chapter 30 Plans, are intrastate access rates**
17 **subject to change under the PSI/SPI formula?**

18 **A.** Yes, the definition of "noncompetitive services" was spelled out in Section
19 3002 of the original Chapter 30 law as follows: "The term includes any
20 protected telephone service as defined under this chapter or a service that
21 has been determined by the PaPUC as not a competitive service." The
22 term "protected telephone service" was equally spelled out as "including
23 the following telecommunications services provided by a local exchange
24 telecommunications company, unless the commission determines, after

1 notice and hearing, that the service is competitive: (1)
2 Telecommunications service provided to business or residential
3 consumers that is necessary for completing a local exchange call. (2)
4 Touch-tone service. (3) Switched-access service. (4) Special-access
5 service. (5) Ordering, installation, restoration and disconnection of these
6 services." These same definitions are included in the D&E carriers'
7 Chapter 30 Plans. The access rates at issue in this bifurcated proceeding
8 are applicable to the switched access services described in section 3 of
9 this definition. Clearly, as a *protected service included in the definition of*
10 *noncompetitive service*, access rates are subject to change pursuant to
11 the Companies' PSM, including the PSI formula and related annual filing.

12 **Q. Are there any provisions anywhere in the Chapter 30 Plans that**
13 **specifically exclude revenues from protected services in general,**
14 **and access services in particular, from the PSM calculations?**

15 A. No, there is no language in the D&E carriers' Chapter 30 Plans that
16 specifically excludes protected services' revenues from the price cap
17 formula calculations or protected services' rates from increases in rates.
18 As a matter of fact, the PSM specifically sets forth the principles and
19 procedures applicable to changes in each carrier's rates for
20 *noncompetitive rates, which includes protected services*. It is only
21 pursuant to the PSM that the D&E carriers may raise the rates for
22 protected services, including access rates. Switched access service is
23 identified as a noncompetitive service in the Chapter 30 Plans, which
24 means switched access rates are subject to the same pricing flexibility

1 afforded other noncompetitive services in the D&E carriers' Chapter 30
2 Plans.

3 **Q. You mentioned that once an allowed revenue change is determined**
4 **pursuant to the PSI formula, that revenue increase is allocated at the**
5 **carriers' discretion among noncompetitive rates. Is there any limit**
6 **on the carriers' discretion over how they allocate the allowable**
7 **revenue increase among noncompetitive services?**

8 A. Part 3.D. of the plans (D&E Telephone Plan at pages 18-19), contains the
9 Consumer Protections on the operations of the PSM. According to this
10 part, "all rate changes proposed either under the PSM formula, including
11 exogenous events, or under the rate restructuring and rebalancing
12 provisions of this Plan shall be approved if just and reasonable and if a
13 proposed tariff does not cause one of the following to occur and is
14 otherwise in compliance with this Plan: (a) The SPI is not greater than the
15 PSI [essentially meaning that no price changes have been implemented in
16 an amount greater than the PSI would have allowed]; and (b) The
17 proposed changes to basic, local rates for both residential and small
18 business customers (three (3) lines or less), by any combination of filings,
19 will not cause an increase in the rates in existence at the end of the
20 preceding year greater than \$3.50 per month." Consequently, under the
21 plans, there is no limitation on the allocation of the allowable revenue
22 increase to intrastate access charges.

23 **Q. Please describe the D&E carriers' network obligations under their**
24 **original Chapter 30 Plans.**

1 A. Under the original Chapter 30 law, there were several different
2 requirements for network modernization. For example, the D&E carriers'
3 initial plans had benchmarks in their NMPs addressing the deployment of
4 specific network such as digital switches, and specific technologies and/or
5 services such as ISDN and SS-7. Most importantly, the carriers had
6 benchmarks for deployment of broadband capability to any customer
7 within 5 business days of receipt of the request. For the D&E carriers, the
8 broadband deployment obligations were as follows:

	1998	2003	2008	2013	2015
D&E	0%	30%	50%	70%	100%
CTTC	10%	30%	50%	70%	100%
BVTC	10%	30%	50%	70%	100%

9 The obligation to ubiquitously deploy a modern network without
10 regard for customer demand for any of the services or consideration of
11 any company return on providing any of the services was the quid pro quo
12 for being afforded the flexibility of alternative regulation, including the
13 ability to raise noncompetitive service rates, including access rates, on an
14 annual basis pursuant to a prescribed formula described above.

15 **Q. Again, do any of the stated restrictions prohibit the D&E carriers**
16 **from increasing intrastate switched access rates?**

17 A. No, the PaPUC did not state anywhere that it was implementing a freeze
18 of intrastate rural ILEC access rates nor did the PaPUC state anywhere

1 that it was altering or changing any rural ILECs Amended Chapter 30
2 Plans to preclude access charge changes.

3 **Act 183 and Amended Chapter 30 Plans**

4 **Q. Do the D&E carriers continue to operate under their original Chapter**
5 **30 Plans?**

6 A. Yes, as amended. The original Chapter 30 law was subject to sunset on
7 December 31, 2003. Although the original law did sunset without being
8 reauthorized, the PaPUC issued a policy statement effectively continuing
9 the operation of all plans. Then, on November 30, 2004, the Governor
10 signed into law Act 183, 66 Pa.C.S. §§3011-3019 which is replacement
11 legislation for the original Chapter 30 law.

12 **Q. Did Act 183 change the D&E Carriers' Chapter 30 Plans?**

13 A. Act 183 contains provisions that provided ILECs several options, including
14 remaining under their existing plans, or choosing options to amend their
15 NMPs. If an ILEC chose to amend its NMP, other changes to its plan
16 were warranted as well.

17 **Q. Please describe the options available to the D&E carriers with**
18 **respect to their original Chapter 30 Plans.**

19 A. Act 183 commences with a provision that preserves the existing Chapter
20 30 Plans. Section 3013(a) of Act 183 provides that, "an Alternative Form
21 of Regulation Plan and Network Modernization Plan approved by the
22 commission for a local exchange telecommunications company as of
23 December 31, 2003, shall remain valid and effective, except as may be
24 amended at the election of the local exchange telecommunications

1 company as authorized by this Chapter. The commission shall allow a
2 previously approved plan to be amended to conform to any changes made
3 under this Chapter, and shall not require any other changes to the plan."
4 Section 3014 of the Act then provides ILECs several options with respect
5 to their existing NMPs. For each option elected, there are corresponding
6 ramifications elsewhere throughout the Act.

7 **Q. Please describe the options to amend the NMPs that were available**
8 **to the D&E carriers and the corresponding changes to the carriers'**
9 **alternative form of regulation that flowed from those NMP**
10 **amendments.**

11 A. Under Section 3014(a), the D&E carriers could have elected to make no
12 amendments to their NMPs, and would have retained the existing
13 obligation to deploy broadband throughout all of their service territories by
14 2015, while also maintaining the corresponding intervening benchmarks
15 that would have put each D&E carrier at only 50% deployment by 2008. If
16 making this choice, the carriers got no other relief to their existing PSP, or
17 the ratemaking part of their alternative regulation plans.

18 Section 3014(b) of Act 183 also set out essentially five other
19 options available to ILECs, three of which were available only to rural
20 ILECs (which include the D&E carriers), and two of which were available
21 only to nonrural ILECs (essentially the Verizon companies).

22 Under Section 3014(b)(1), the D&E carriers could have elected to
23 amend their NMPs to accelerate 100% broadband availability by 7 years,
24 or from December 31, 2015, to full deployment by December 31, 2008.

1 Under Section 3014(b)(2)(II)(a), the carriers could have elected to amend
2 their NMPs to accelerate broadband availability to 80% of their access
3 lines by December 31, 2010 and 100% by December 31, 2013. Finally,
4 under Section 3014(b)(2)(II)(b), the D&E carriers could have elected to
5 amend their NMPs to accelerate broadband availability to 80% of their
6 access lines by December 31, 2010 and 100% by December 31, 2015.
7 Each of these options required the D&E carriers to accelerate their
8 existing network modernization plans significantly. Even if the D&E
9 carriers chose the Section 3014(b)(2)(II)(b) option, which retained an end-
10 date for ubiquitous deployment of 2015, they were still required to
11 accelerate their interim deployment benchmark significantly to 80% by the
12 year 2010, whereas their existing commitments were at only 50% by 2008
13 and only 70% by 2013. Thus, even if they chose the most lenient
14 acceleration option available, their interim deployment was still
15 significantly accelerated.

16 **Q. What were the effects on each of the D&E carriers' PSMs from each**
17 **of these NMP options?**

18 A. In exchange for choosing to amend their NMPs, the D&E carriers were
19 provided other relief under Act 183. Most significantly as it pertains to this
20 proceeding, if the carriers elected to amend their NMPs to accelerate
21 broadband deployment as described above, they were afforded relief from
22 the 2% productivity offset (the "X" factor to the inflation-based GDPPI
23 formula for changing rates and increasing noncompetitive service
24 revenues) under Section 3015(a) of the Act.

1 If the D&E carriers elected 100% deployment by 2008 (the
2 3014(b)(1) option), they saw a removal of the entire 2% offset and did not
3 have to implement certain other administrative programs under Act 183
4 such as the Bona Fide Retail Request Program ("BFRR") or the Business
5 Attraction and Retention Program ("BARP"). If they chose the Section
6 3014(b)(2)(II)(a) option, they would likewise be afforded relief from the 2%
7 productivity offset, but still would have had to accelerate to 80% by 2010,
8 and would have had to implement the BFRR and BARP. Finally, if the
9 D&E carriers selected the 3014(b)(2)(II)(b) option, they would retain the
10 2010 acceleration, the BFRR and BARP obligations, and would still have a
11 0.5% offset to their PSI formula.

12 **Q. What option did the D&E carriers choose and why?**

13 A. The D&E carriers chose the Section 3014(b)(1) option, what is commonly
14 referred to as the 100%/2008 option. The D&E carriers chose this option
15 based upon their commitments to bring 100% broadband deployment to
16 their rural service territories as quickly as possible and based upon their
17 belief that the elimination of the 2% inflation offset from their PSI/SPI
18 formula for raising noncompetitive services rates and revenues would
19 provide them with the additional annual revenues to carryout their 100%
20 network commitment by December 31, 2008. Full elimination of the 2%
21 offset was a critical consideration factoring into our choice as it provided
22 us the greatest opportunity to realize the revenues and cash flow
23 necessary for offsetting the costs associated with 100% deployment by
24 December 31, 2008. Compared to the D&E carriers' original deployment

1 obligations of 50% by 2008 and 100% by 2015, this accelerated
2 commitment was substantial, and could only be achieved if the D&E
3 carriers were afforded the full opportunity to achieve the revenue levels
4 envisioned under Section 3015(a) of Act 183.

5 The accelerated network commitments were also made with the
6 understanding and belief that the D&E carriers retained the right under
7 their Amended Chapter 30 Plans to increase rates for protected services
8 under the PSI/SPI, which as earlier explained included the right to
9 increase intrastate access charges as a protected service. If we had been
10 informed that there was some implied prohibition that our intrastate access
11 rates had been frozen by the PaPUC, the D&E carriers may not have
12 been able to make the 100% accelerated broadband commitments to their
13 rural service territories by December 31, 2008.

14 **Q. Did the D&E carriers file amended Chapter 30 Plans consistent with**
15 **their Section 3014(b)(1) option?**

16 A. Yes, on February 25, 2005.

17 **Q. Does Act 183 also address changes in access rates?**

18 A. Yes, as was the case in the original Chapter 30 law, access service falls
19 under the definition of a protected service, and a protected service is a
20 noncompetitive service (see Section 3012 of Act 183). Switched access
21 service is likewise defined in the Act as including, but not limited to, local
22 switching, common and dedicated transport and the carrier charge. In
23 addition, Act 183 provides that the PaPUC may not require a local
24 exchange telecommunications carrier to reduce access rates except on a

1 revenue-neutral basis (see Section 3017 of Act 183). As a protected
2 service, Act 183 ensures that customer "pay only reasonable charges for
3 protected services which shall be available on a nondiscriminatory basis."
4 (See Section 3011(3) of Act 183).

5 **Q. Does Act 183 prohibit ILECs from increasing access rates?**

6 A. No, there is no language whatsoever in Act 183 that prohibits ILECs from
7 increasing access rates. In fact, by continuing to include access services
8 in the noncompetitive bucket of services subject to the alternative
9 regulation of the annual PSI/SPI filing, Act 183 specifically endorses the
10 principle that access rates may be increased by operation of the PSI/SPI,
11 which is the exclusive means by which the D&E carriers' noncompetitive
12 services are regulated. The wording of the D&E carriers' Amended
13 Chapter 30 Plans is directly consistent with the provisions of the Act.
14 Based on that, the D&E carriers retained the right to adjust their intrastate
15 access charges as long as they remained consistent with the Global
16 Order. More specifically, it was our understanding that we retained the
17 right and flexibility in accordance with Act 183 and our Amended Chapter
18 30 Plans to change all noncompetitive rates, subject to the terms of our
19 PSI/SPI. This allowed us to increase our CC rates as long as we
20 continued to remain below the rates established in the Global Order and
21 allowed us to continue prior PaPUC approved orders that provided for
22 mirroring of our interstate rates to avoid arbitrage.

23 **Q. Have the D&E carriers' Amended Chapter 30 Plans been found to be**
24 **in compliance with Act 183?**

1 A. Yes, by Order entered June 3, 2005, the PaPUC ordered "that the Petition
2 for an Amended Alternative Regulation and Network Modernization Plan
3 for the Denver and Ephrata Telephone and Telegraph Company (Docket
4 Number P-00981430F1000) is hereby approved, as in compliance with
5 Act 183 of 2004, P.L. 1398 (66 Pa.C.S. §§3011-3019), consistent with this
6 Order." By Order entered June 3, 2005, the PaPUC ordered "that the
7 Petition for an Amended Alternative Regulation and Network
8 Modernization Plan for the Conestoga Telephone and Telegraph
9 Company (Docket Number P-00981429F1000) is hereby approved, as in
10 compliance with Act 183 of 2004, P.L. 1398 (66 Pa.C.S. §§3011-3019),
11 consistent with this Order." By Order entered June 3, 2005, the PaPUC
12 ordered "that the Petition for an Amended Alternative Regulation and
13 Network Modernization Plan for the Buffalo Valley Telephone Company
14 (Docket Number P-00981428F1000) is hereby approved, as in compliance
15 with Act 183 of 2004, P.L. 1398 (66 Pa.C.S. §§3011-3019), consistent with
16 this Order."

17 **June 28 Compliance Filings Justification**

18 **Q. Verizon, in its amicus pleading filed on July 20, 2006, claims that the**
19 **D&E carriers' increases in switched access charges represent an**
20 **"unprecedented proposal." Do you agree?**

21 A. No. For the most part, the D&E carriers' June 28 Compliance Filings'
22 increases in switched access charges represent nothing more than a
23 continuation of the long-approved PaPUC policy of mirroring of interstate
24 rates. In fact, of the \$2,038,892 in total additional revenues associated

1 with the access increases, \$1,295,871 or 65% are attributable to mirroring
2 of interstate rates. The PaPUC's mirroring policy has been a means to
3 curb interexchange carriers' gaming of the access system by
4 mischaracterizing interstate traffic as intrastate, or vice versa, in order to
5 gain access to the lowest rate, i.e. arbitrage. As stated in the PaPUC's
6 Global Order at page 151: "The rate restructuring tariffs the affected
7 companies [rural ILECs] must file should include changes to their
8 intrastate access charges to match their federal tariffs." Verizon, in the
9 Global proceeding and thereafter, has not opposed the mirroring of
10 intrastate and interstate access charges. The D&E carriers further believe
11 that Verizon, before the FCC, has also supported the mirroring of
12 intrastate and interstate switched access charges to avoid arbitrage.
13 Consequently, the D&E carriers' increases to mirror their switched access
14 charges are directly consistent with PaPUC precedent and there is nothing
15 unprecedented about these rate changes.

16 Turning next to the small CC monthly per-line rate increases
17 implemented by D&E Telephone and Buffalo Valley of \$1.13 and \$0.91,
18 respectively, there is likewise nothing "unprecedented" about these minor
19 rate changes. The PaUSF Plan sponsored by Verizon and the RTCC and
20 adopted in the Global Order was designed to result in the rural ILECs
21 establishing a monthly benchmark CC of \$7.00 per line. Nevertheless, (i)
22 D&E Telephone initially established its CC at \$6.11 per line or \$0.89 below
23 the \$7.00 benchmark and subsequently through voluntary reductions
24 lowered the rate to \$5.17 through the Chapter 30 process and (ii) Buffalo

1 Valley initially established its CC at the benchmark of \$7.00 per line and
2 subsequently through voluntary reductions lowered the rate to \$5.11
3 through the Chapter 30 process. Even after the June 28 Compliance
4 Filings' minimal increases in the CCs, their rates remain significantly
5 below the \$7.00 benchmark whereas most other rural ILECs' CC rates
6 now are significantly above the benchmark rate. See D&E Exhibit 1. The
7 D&E carriers' access customers, including Verizon, have and are realizing
8 substantial expense reductions as a result of our efforts expediting access
9 charge reform.

10 **Q. Please highlight the D&E carriers' efforts in achieving access charge**
11 **reform in Pennsylvania.**

12 A. As shown in D&E Exhibits 1, 3 and 4, the D&E carriers have been
13 frontrunners, commencing with the Global Order, in implementing
14 switched access service charge reform in Pennsylvania. Virtually every
15 state access rate element for all three D&E carriers has been reduced
16 from where it was at the time of the Global Order and the carrier charge
17 for the D&E carriers is significantly reduced from where it was at the time
18 of the Global Order. On the other hand, the D&E carriers' Local Service
19 rates are 160% to 200% of what they were at the time of the Global Order
20 as part of the D&E carriers' rate rebalancing efforts.

21 **Q. Even after the June 28 Compliance Filings, are D&E carriers' access**
22 **rates still below the level established by the PaPUC in the Global**
23 **proceeding?**

1 A. Yes. The D&E carriers' access rates, as shown in D&E Exhibit 3, are still
2 significantly below the level established by the PaPUC when the D&E
3 carriers' PaUSF support levels were calculated in Global.

4 As shown, the D&E carriers' access charge changes commencing
5 with the Global proceeding represent substantial progress. The
6 beneficiaries of these voluntary changes have been Verizon and the other
7 access carriers. Verizon and the other access carriers have actually
8 experienced overall access charge savings because the D&E carriers
9 have voluntarily and aggressively reduced access rates via several rate-
10 rebalancing filings that were affected subsequent to the approval of their
11 Chapter 30 Plans. The D&E carriers rate rebalanced in 2001, 2002 and
12 2003. See D&E Exhibits 3 and 4. Although the D&E carriers increased
13 access rates in their June 28 Compliance Filings, their access rates
14 remain lower than the rate level established in the Global Order and that
15 of other rural telephone companies located in Pennsylvania. Since the
16 Global Order, carriers such as Verizon have enjoyed the benefit of
17 significant access charge savings due to D&E's aggressive rate
18 rebalancing. Had the D&E carriers elected not to do any voluntary access
19 reductions, their access rates would be much higher than they are today
20 yet still be in accordance with all PaPUC orders. In contrast, the D&E
21 carriers' local exchange ratepayers have been forced to bear the
22 consequences of its access charge rate reform efforts by paying
23 substantially higher basic exchange rates. In today's competitive markets,
24 further increases in basic exchange rates just does not make sense.

1 **Q. Please specifically identify the impact access charge reform has had**
2 **on the D&E carriers' basic exchange rates.**

3 **A. In carrying out this access charge reform, the D&E carriers have**
4 **transferred the revenue burden to their local exchange rates. As shown in**
5 **D&E Exhibit 4 and summarized below, their R-1 and B-1 local exchange**
6 **rates have significantly increased:**

D&E Telephone

R-1 Rate

Pre-Global	\$7.37 to 10.47
Global	\$7.55 to 10.74
Current	\$15.69 to 17.85

B-1 Rate

Pre-Global	\$14.38 to 20.43
Global	\$14.38 to 20.43
Current	\$21.05 to 25.10

Conestoga

R-1 Rate

Pre-Global	\$5.83 to 8.41
Global	\$6.08 to 8.80
Current	\$12.46 to 15.18

B-1 Rate

Pre-Global	\$11.67 to 16.83
Global	\$11.67 to 16.83
Current	\$15.55 to 20.71

Buffalo Valley

R-1 Rate

Pre-Global	\$ 7.00
Global	\$ 7.04
Current	\$14.50

B-1 Rate

Pre-Global	\$14.00
Global	\$14.00
Current	\$18.10

1 **Q. Did any of the D&E carriers' post Global Order rate changes,**
2 **including the June 28 Compliance Filings have any impact on their**
3 **PaUSF support levels?**

4 A. No, none of the D&E carriers' post-Global rate filings had any impact on
5 their PaUSF support levels because the access rates and revenue
6 reductions associated therewith were offset by local service rate
7 increases, i.e., the filings were revenue neutral thereby requiring no
8 additional funding from the PaUSF. Likewise, the June 28 Compliance
9 Filings had no impact whatsoever on their universal fund support levels.

10 **Q. Please explain why the D&E carriers elected to implement the**
11 **intrastate access rate revisions in their June 28 Compliance Filings**
12 **in lieu of either further increasing basic exchange rates or banking**
13 **the additional revenue entitlement.**

14 A. Initially, I again note that Buffalo Valley did in fact place part of its Chapter
15 30 revenue entitlement on basic exchange rates. Its basic exchange rates
16 were increased by \$0.30 per month. The reason for the D&E carriers not
17 placing further increases on basic exchange rates but instead placing the
18 additional revenue requirement, in part, on intrastate access services is
19 basically three-fold. First, all three of the D&E carriers, following the
20 adoption of Act 183, committed to accelerate their 100% broadband
21 availability commitments from December 31, 2015 to December 31, 2008.
22 The major regulatory quid pro quo for these accelerated commitments in
23 Act 183 was the elimination of the 2% inflation offset. This inflation offset
24 elimination provides ILECs making such accelerated commitments with

1 the opportunity to achieve higher annual revenues to offset the costs
2 associated with the accelerated commitments.

3 Presently, the D&E carriers are rapidly deploying the network
4 facilities to achieve universal broadband availability within their rural
5 service territories by December 31, 2008. These broadband networks will
6 enhance the robustness of their services. The D&E carriers are incurring
7 significant costs to provide such expedited universal broadband while
8 facing growing competition from wireless carriers and non-facilities based
9 VoIP providers who continue to operate on a far less regulated basis.
10 Further, the broadband commitments and expenditures associated
11 therewith were made and are being made on the assumption the carriers,
12 under their Amended Chapter 30 Plans, will have the opportunity to
13 achieve higher revenues on an annual basis.

14 Second, as earlier explained, under the D&E carriers' Amended
15 Chapter 30 Plans, there is no limitation on their right to increase intrastate
16 access charges. It is our opinion that as long as the D&E carriers'
17 intrastate access charges mirror their interstate charges, their CCs remain
18 below the \$7.00 Global benchmark, and the changes do not violate the
19 Amended Chapter 30 Plans' provisions, the D&E carriers have an
20 absolute right to the rate changes in the June 28 Compliance Filings.

21 **Q. Please explain the third reason for the D&E carriers implementing**
22 **these relatively small increases in intrastate access charges in lieu**
23 **of placing the increases on local exchange rates.**

1 A. Intermodal competition precludes the D&E carriers from making
2 continuous annual increases in local service rates. As broadband is
3 reaching the home of every resident of Pennsylvania, intermodal
4 competition for telephone service is rapidly becoming a major competitive
5 factor. Cell phones and high-speed internet services offered by multiple
6 providers enable mobility and include additional services such as e-mail,
7 instant messaging, and VoIP services that increase consumers'
8 telecommunications options. Businesses are combining voice and data
9 communications onto a single (IP-based) platform and providers are
10 beginning to offer residential customers these economies of scale. Each
11 month, customers switch from their incumbent local exchange service
12 providers to intermodal competitors to realize savings. This intermodal
13 competition has resulted in the D&E carriers losing over 10,550 access
14 lines (D&E Telephone 3,330, Conestoga 5,070, and Buffalo Valley 2,150)
15 over the last three years and all revenues including access revenues
16 associated with such lines.⁷ In recognition of intermodal competition,

⁷The D&E carriers are also facing the consequences of major losses in interstate revenues arising from the FCC's approval of NECA's changes in average schedule formulas. D&E Telephone estimates that the impact of the new formulas and the transition plan on network access revenues will be an approximate \$93,000 reduction for the six-month period beginning July 1, 2006, a reduction of \$524,000 during fiscal year 2007, a reduction of \$927,000 during fiscal year 2008, and an annual reduction of \$1,544,000 thereafter. Conestoga estimates that the impact of the new formulas and the transition plan on network access revenues will be an approximate \$86,000 reduction for the six-month period beginning July 1, 2006, a reduction of \$484,000 during fiscal year 2007, a reduction of \$857,000 during fiscal year 2008, and an annual reduction of \$1,427,000 thereafter. Buffalo Valley estimates that the impact of the new formulas and the transition plan on network access revenues will be an approximate \$9,000 reduction for the six-month period beginning July 1, 2006, a reduction of \$48,000 during fiscal year 2007, a reduction of \$84,000 during fiscal year 2008, and an annual reduction of \$141,000 thereafter.

1 forecasters are now projecting that ILECs stand the possibility of losing
2 over 70% of their access lines by 2013.

3 Line loss due to intense price competition from intermodal
4 competitors inversely increases a rural ILEC's reliance on universal
5 service, which directly contradicts Chapter 30's intent for the incumbents
6 to fund ubiquitous advanced services. Chapter 30 requires that the D&E
7 carriers expedite broadband deployment and incur related expenses. At
8 the same time, intermodal competition is curbing the prices that they may
9 charge for local telephone service and resulting in them losing access
10 lines. The Act 183 legislation provides a means for the D&E carriers to
11 recover some of the costs associated with upgrading their networks to
12 provide universal broadband. The D&E carriers should be permitted to
13 pursue lawful Amended Chapter 30 Plan rate adjustments including minor
14 increases in their switched access in lieu of banking or further increases in
15 local rates. The PaPUC correctly recognized this in the June 23 Order, at
16 12, recognizing "Increases in local rates that produce the kind of access
17 services line losses the Company wants to avoid could contravene the
18 PaPUC's legal obligation to preserve universal service in Pennsylvania
19 and unnecessarily increase funding demands on PaUSF in advance of
20 any national intercarrier compensation reform."

21 **Q. The PaPUC's Opinions and Orders entered December 8, 2006**
22 **addressing the D&E carriers' petitions for reconsideration seem to**
23 **downplay this intermodal competition contention stating that the**
24 **argument fails to consider access line loss due to customers moving**

1 to their own DSL service that is non-jurisdictional, or intermodal
2 services provided by its own parent company D&E Communications,
3 Inc., which provides cell phone, cable modem, and broadband phone
4 services through high speed internet services. Please comment on
5 **this assertion.**

6 A. The D&E carriers have encountered line losses of 10,550 over the last
7 three years. Contrary to this Order, our provision of DSL is responsible for
8 only causing an insignificant portion of this line loss. In fact, an access
9 line is **required** in order to receive DSL service, thus the sale of the DSL
10 actually protects our line counts. While second lines for dial up may be at
11 risk, our data indicates that our DSL service affecting second line
12 disconnects has only given rise to about 1% of our line losses.
13 Furthermore, contrary to the Order, D&E does not provide cell phone
14 service anywhere, nor does it provide telephone service via cable modem
15 within its RLEC service territories. The record and supporting data in this
16 proceeding do not justify these false statements. Based upon the actual
17 facts, intermodal competition, especially from wireless carriers such as
18 Verizon Wireless, has and will continue to have a significant adverse
19 impact on our access lines, revenues and financial standing.

20 **Q. Why was banking not an appropriate option?**

21 A. Simply banking the increases was not an option since it would provide no
22 revenues whatsoever to assist in funding the expenditures associated with
23 the accelerated broadband commitments. As Vice Chairman Cawley
24 accurately and succinctly stated in his Statement regarding the

1 Companies' 2006 PSI/SPI filing to increase access rates, "Staff
2 recommended alternatives do not provide the optimal resolution of the
3 interlinked issues that the Companies' 2006 PSI/SPI submissions have
4 generated. The alternatives to either bank or reallocate the proposed
5 revenue increases to the Companies' respective basic local exchange
6 services, rather than channeling such increases to the Companies'
7 intrastate carrier access services, generate other less than desirable
8 implications. Banking the proposed revenue increases creates the usual
9 problems of inter-generational equity. Eventually, the Companies' non-
10 competitive services and the end-users of such services may have to
11 absorb part or all of the banked revenue increases some time in the future
12 on top of new automatic annual PSI/SPI revenue and rate increases." "I
13 believe that in considering the most optimal among the "second best"
14 choices, the PaPUC should be guided by principles that first safeguard the
15 interests of the Companies' end-user customers that have a lesser
16 number of competitive choices and traditionally exhibit a lesser price
17 elasticity of demand. These are the end-user customers for basic local
18 exchange services." (Statement of James H. Cawley dated June 22,
19 2006.)

20 The switched access charge increases resulting from the June 28
21 Compliance Filings were the only realistic option for the D&E carriers to
22 have any possibility of achieving the additional revenues due to them
23 under Act 183 and their Amended Chapter 30 Plans. The switched
24 access increases will in no way impede competition, particularly the

1 competition our companies are facing and will continue to face from
2 wireless, cable, and VoIP competitors. Moreover, the increases, for the
3 most part, arise from mirroring interstate rates which has been the position
4 of the PaPUC. The D&E Telephone and Conestoga increases in the CC
5 are de minimus and the rates remain below the Global benchmark.

6 With the ongoing losses in access lines due to the competitive
7 forces in the marketplace, the D&E carriers respectfully believe that, at
8 this time, the minor adjustments in their switched access charges were the
9 only reasonable and lawful way for them to achieve the revenues
10 necessary to offset the ongoing costs of providing public service including
11 the rising costs associated with their accelerated Chapter 30 network
12 modernization programs. Increasing local rates and/or banking were not
13 viable options in today's competitive business environment.

14 **Q. If the D&E carriers were not allowed to increase access rates, what**
15 **alternatives would they be forced to pursue?**

16 A. The D&E carriers would be forced to increase local service rates to a level
17 in excess of the rate cap (\$18.00) currently in place. The D&E highest R-1
18 rates would have gone to \$19.43 and the Conestoga highest R-1 rate
19 would have gone to \$16.70. Thus, they would then have been forced to
20 request increased PaUSF funding to recover the amount of local service
21 rates in excess of the rate cap. Moreover, the Buffalo Valley R-1 rate
22 would have risen to \$15.54 forcing more customers from the network. In
23 other words, due to intense intermodal competition, the D&E carriers
24 would have accelerated the loss of access lines by charging customers

1 much higher local rates. In our opinion, the lost revenue arising from such
2 loss of access lines would have been greater than any increased PaUSF
3 funding.

4 **Cost Data**

5 **Q. Is cost data required for proposed rate changes in a PSI/SPI rate**
6 **filing?**

7 A. Our Amended Chapter 30 Plans are really not clear on that question. Part
8 3, Section D., Paragraph 3 of the plans provides that "The Company shall
9 submit cost data for existing noncompetitive rate changes." The rate
10 changes in the June 26 Compliance Filings were proposed rate changes,
11 not existing noncompetitive rate changes. Moreover, the plans do not
12 provide for cost studies by access service rate element. Nevertheless, we
13 do possess cost support to justify the June 26 Compliance Filings rates.

14 **Q. Do the D&E carriers at this time possess any embedded cost study**
15 **by access tariff rate element?**

16 A. No, the only cost allocation rules I am familiar with are the FCC's 47CFR
17 Part 36, Part 64 and Part 69 cost allocation rules. Part 64 rules address
18 the allocation of total company financial account information per 47CFR
19 Part 32 between regulated and non-regulated operations. Part 36 rules
20 address the allocation of regulated only financial account information
21 calculated pursuant to Part 64 between the intrastate and interstate
22 jurisdictions. Part 69 rules address the allocation of the interstate
23 amounts calculated under Part 36 rules to the appropriate rate elements
24 the FCC has established for access tariff filing. These allocation rules

1 apply only to companies that are considered cost companies, which
2 include carriers regulated on both a rate of return basis and on a price cap
3 basis in the interstate jurisdiction. For companies that are classified as
4 average schedule companies pursuant to FCC rules, NECA develops
5 interstate costs for these companies based on formulas and algorithms
6 using the financial regulated costs of the average schedule companies
7 and cost characteristics of similar sized cost companies. These
8 calculations are performed annually and filed with the FCC for review and
9 comment by any and all interested parties. To date, no carrier operating
10 in Pennsylvania or any other party have ever questioned or filed
11 exceptions to these filings to the best of my knowledge. The D&E carriers
12 have always been and continue to be classified as average schedule
13 companies and thus rely on the calculations performed and filed by NECA
14 for determining interstate costs and settlements.

15 **Q. Why are the June 28 Compliance Filings' intrastate access rates of**
16 **the D&E carriers reflective of cost?**

17 A. The D&E companies are participants in NECA's tariff and settlement
18 process. They utilize the services of NECA which calculates interstate
19 access rates and distribute interstate access revenues amongst the
20 participants. NECA annually in accordance with 47CFR FCC Part 61.38
21 rules calculates interstate access rates on behalf of its member
22 participants. These filings are reviewed by the FCC and permitted to
23 either become effective or are suspended for further investigation. The
24 interstate traffic sensitive switched access rates utilized by the D&E

1 carriers for their 2006 intrastate PSI/SPI filings were the rates the FCC
2 allowed NECA to become effective in July 2005. Because these rates are
3 based on costs in accordance with FCC rules and because the network is
4 no different when making an interstate call than in making an intrastate
5 call, the use of interstate access rates for intrastate purposes by de facto
6 makes the intrastate rates cost based. The PaPUC has accepted this
7 premise when they accepted the use of interstate traffic sensitive switched
8 access rates for intrastate purposes in the Global Order and 2003 Joint
9 Stipulation Order.

10 **Q. Does any data exist identifying the D&E carriers' specific interstate**
11 **costs?**

12 **A.** Yes, as part of the required monthly settlement process with NECA, NECA
13 calculates the specific traffic sensitive switched access and common line
14 interstate cost settlements in accordance with the average schedule
15 formulas and algorithms referenced above, which were approved by the
16 FCC, along with actual data reported by the specific D&E carriers to
17 generate the companies specific interstate traffic sensitive switched
18 access and common line cost settlements. Taking these actual cost
19 settlements and dividing by the actual demand units of minutes and lines
20 produces each company's actual average interstate cost settlement
21 amount per unit for traffic sensitive switched access and common line.

22 **Q. What are the cost recovery amounts the D&E carriers received from**
23 **NECA in 2005 to recover the D&E carriers' interstate costs?**

1 A. D&E Exhibit 5 displays the total settlements and the calculated amount
2 per minute of use or per line the D&E carriers received from the interstate
3 jurisdiction to recover their interstate costs in accordance with FCC cost
4 allocation rules for the year 2005.

5 Q. **How do the interstate cost-based common line amounts per line**
6 **compare to the new intrastate carrier charge rate?**

7 A. D&E Exhibit 6 displays the comparison of the interstate calculated
8 common line amount per line to the proposed intrastate carrier charge.
9 The exhibit proves that the intrastate carrier charge rates are below what
10 the D&E carriers' interstate calculated cost based common line settlement
11 rates per line are.

12 Q. **Citing the “Joint Access Proposal” addressed in the 2003 Joint**
13 **Stipulation Order, at Docket No. M-00021596, the December 8, 2006**
14 **orders on reconsideration at least imply that a D&E carrier must**
15 **produce “substantive cost data to prove that its access charges are**
16 **below costs and need to be increased.” Would you please**
17 **comment?**

18 A. Yes. In my opinion, the December 8, 2006 Orders have misconstrued
19 paragraph 3 of the joint proposal. Specifically, paragraph 3 provided that,
20 “Each ILEC reserves the right, subject to Chapter 30 Plan requirements, to
21 change its access rates to ensure that each access rate element at least
22 **recovers its costs and the ILEC’s service price index continues to be**
23 **equal to or less than the ILEC’s price stability index, in the event the**
24 **ILEC’s access rates are determined to be below cost based upon the**

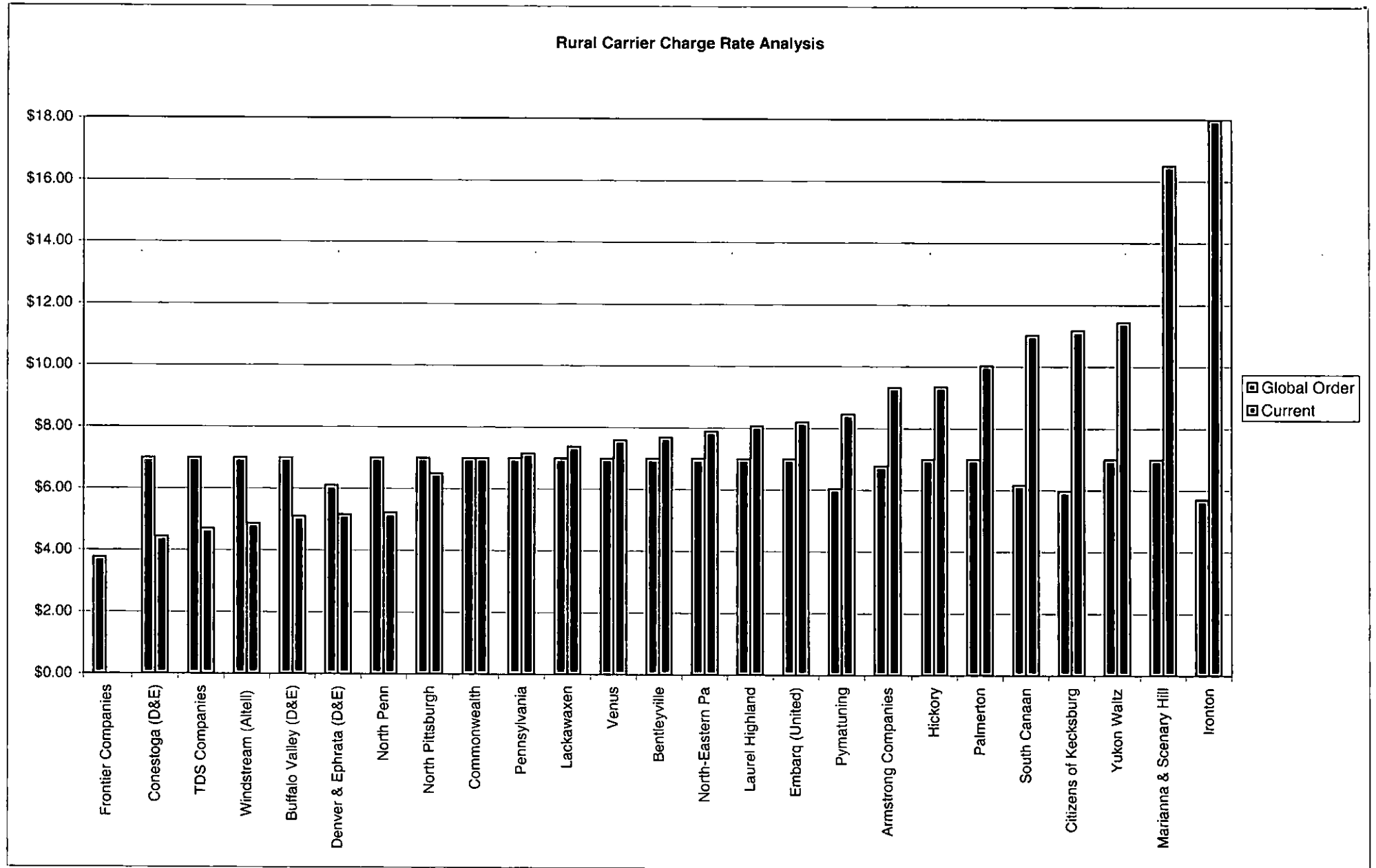
1 **development of a cost study.”** (emphasis added) This provision was
2 not intended to preclude the rural ILECs from increasing their access rates
3 pursuant to the provisions of their Chapter 30 Plans when cost recovery is
4 not at issue. Instead, it was intended to ensure that the rural ILECs
5 retained the right to adjust their access charges when necessary to assure
6 they recovered their cost. The facts in the 2006 Filings reveal that the
7 D&E carriers’ intrastate access charges were below their cost based
8 interstate rates.

9 **Q. Does this conclude your direct testimony?**

10 **A.** Yes, at this time.

PA ILEC CC Comparison

Pa RLEC	<u>Carrier Common Line Charge</u>		
	Current Rate	per Global Order	Incr (Decr)
Ironton	\$ 17.99	\$5.70	\$ 12.29
Marianna & Scenary Hill	\$ 16.50	\$7.00	\$ 9.50
Armstrong - Pa	\$ 12.44	\$6.78	\$ 5.66
Yukon Waltz	\$ 11.45	\$7.00	\$ 4.45
Citizens of Kecksburg	\$ 11.18	\$5.97	\$ 5.21
South Canaan	\$ 11.02	\$6.17	\$ 4.85
Palmerton	\$ 10.03	\$7.00	\$ 3.03
Hickory	\$ 9.34	\$7.00	\$ 2.34
Pymatuning	\$ 8.46	\$6.05	\$ 2.41
Embarq (United)	\$ 8.20	\$7.00	\$ 1.20
Laurel Highland	\$ 8.07	\$7.00	\$ 1.07
North-Eastern Pa	\$ 7.88	\$7.00	\$ 0.88
Bentleyville	\$ 7.68	\$7.00	\$ 0.68
Venus	\$ 7.59	\$7.00	\$ 0.59
Lackawaxen	\$ 7.38	\$7.00	\$ 0.38
Pennsylvania	\$ 7.16	\$7.00	\$ 0.16
Commonwealth	\$ 7.00	\$7.00	\$ -
North Pittsburgh	\$ 6.507	\$7.00	\$ (0.493)
North Penn	\$ 5.23	\$7.00	\$ (1.77)
Windstream (Altell)	\$ 4.88	\$7.00	\$ (2.12)
TDS - M&M	\$ 4.78	\$7.00	\$ (2.22)
TDS - Sugar Valley	\$ 4.63	\$7.00	\$ (2.37)
Frontier - Oswayo River	\$ 0.17	\$3.78	\$ (3.61)
Frontier - Breezewood	\$ -	\$3.78	\$ (3.78)
Frontier - Canton	\$ -	\$3.78	\$ (3.78)
Frontier - Lakewood	\$ -	\$3.78	\$ (3.78)
Frontier - Pa	\$ -	\$3.78	\$ (3.78)
Buffalo Valley	\$ 5.11	\$7.00	\$ (1.89)
Conestoga	\$ 4.44	\$7.00	\$ (2.56)
Denver & Ephrata	\$ 5.17	\$6.11	\$ (0.94)



D&E EXHIBIT 2

PROPRIETARY

STATE ACCESS REDUCTIONS

BVT State Access Tariff PA PUC No. 8	4/1/2000	6/26/2001	7/1/2002	7/1/2003	11/1/2003	07/01/06	Chg from Global
Carrier Common Line	\$ 7.00	\$ 6.50	\$ 6.00	\$ 4.79	\$ 4.20	\$ 5.11	(\$1.89)
Entrance Facility - VG 2 Wire	\$ 38.03	\$ 27.58	\$ 22.29	\$ 22.29	\$ 22.29	\$ 22.29	(\$15.74)
Entrance Facility - VG 4 Wire	\$ 60.85	\$ 44.13	\$ 35.67	\$ 35.67	\$ 35.67	\$ 35.67	(\$25.18)
Entrance Facility - DS1	\$ 197.77	\$ 143.41	\$ 115.90	\$ 115.90	\$ 115.90	\$ 115.90	(\$81.87)
Entrance Facility - DS3	\$ 2,294.21	\$ 1,663.65	\$ 1,344.56	\$ 1,344.56	\$ 1,344.56	\$ 1,344.56	(\$949.65)
Direct Trunked Facility - VG	\$ 2.72	\$ 1.97	\$ 1.59	\$ 1.59	\$ 1.59	\$ 1.59	(\$1.13)
Direct Trunked Facility - DS1	\$ 21.84	\$ 15.84	\$ 12.80	\$ 12.80	\$ 12.80	\$ 12.80	(\$9.04)
Direct Trunked Facility - DS3	\$ 166.59	\$ 120.80	\$ 97.63	\$ 97.63	\$ 97.63	\$ 97.63	(\$68.96)
Direct Trunked Termination - VG	\$ 27.22	\$ 19.74	\$ 15.95	\$ 15.95	\$ 15.95	\$ 15.95	(\$11.27)
Direct Trunked Termination - DS1	\$ 113.34	\$ 82.19	\$ 66.43	\$ 66.43	\$ 66.43	\$ 66.43	(\$46.91)
Direct Trunked Termination - DS3	\$ 618.86	\$ 448.77	\$ 362.70	\$ 362.70	\$ 362.70	\$ 362.70	(\$256.16)
Multiplexing DS3 to DS1	\$ 532.22	\$ 385.94	\$ 311.92	\$ 311.92	\$ 311.92	\$ 311.92	(\$220.30)
Multiplexing DS1 to VG	\$ 205.48	\$ 149.00	\$ 120.42	\$ 120.42	\$ 120.42	\$ 120.42	(\$85.06)
Tandem Switching	\$ 0.000656	\$ 0.000476	\$ 0.000385	\$ 0.000385	\$ 0.000385	\$ 0.002787	\$0.002131
Tandem Switched Termination	\$ 0.000314	\$ 0.000228	\$ 0.000184	\$ 0.000184	\$ 0.000184	\$ 0.000184	(\$0.000130)
Tandem Switched Facility	\$ 0.000060	\$ 0.000044	\$ 0.000036	\$ 0.000036	\$ 0.000036	\$ 0.000036	(\$0.000024)
Transport Interconnection Charge	\$ 0.009179	\$ 0.006656	\$ 0.005379	\$ 0.005379	\$ 0.005379	\$ 0.005379	(\$0.003800)
Signaling Mileage Facility	\$ 4.46	\$ 4.46	\$ 4.46	\$ 4.46	\$ 4.46	\$ 4.46	\$0.00
Signaling Mileage Termination	\$ 44.80	\$ 44.80	\$ 44.80	\$ 44.80	\$ 44.80	\$ 44.80	\$0.00
Signaling Entrance Facility	\$ 57.89	\$ 57.89	\$ 57.89	\$ 57.89	\$ 57.89	\$ 57.89	\$0.00
STP Port	\$ 420.10	\$ 420.10	\$ 420.10	\$ 420.10	\$ 420.10	\$ 420.10	\$0.00
800 D/B Query - Basic	\$ 0.0073	\$ 0.0073	\$ 0.0073	\$ 0.0073	\$ 0.0073	\$ 0.0073	\$0.0000
800 D/B Query - Vertical Feature	\$ 0.0076	\$ 0.0076	\$ 0.0076	\$ 0.0076	\$ 0.0076	\$ 0.0076	\$0.0000
Local Switching	\$ 0.017839	\$ 0.012936	\$ 0.010455	\$ 0.010455	\$ 0.010455	\$ 0.010702	(\$0.007137)
Information Surcharge	\$ 0.000129	\$ 0.000094	\$ 0.000076	\$ 0.000076	\$ 0.000076	\$ 0.000076	(\$0.000053)
Total Composite TS per MOU	\$ 0.027521	\$ 0.019958	\$ 0.016130	\$ 0.016130	\$ 0.016130	\$ 0.016377	(\$0.011144)

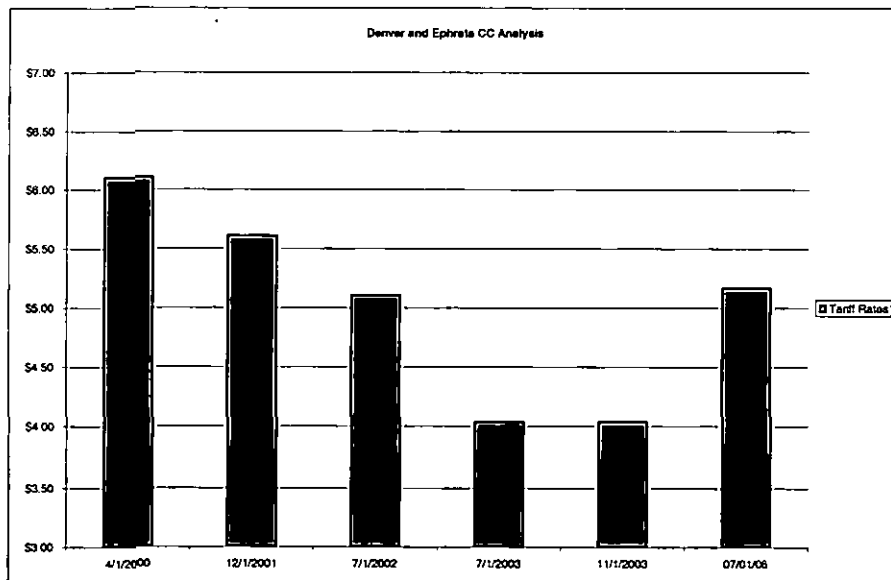
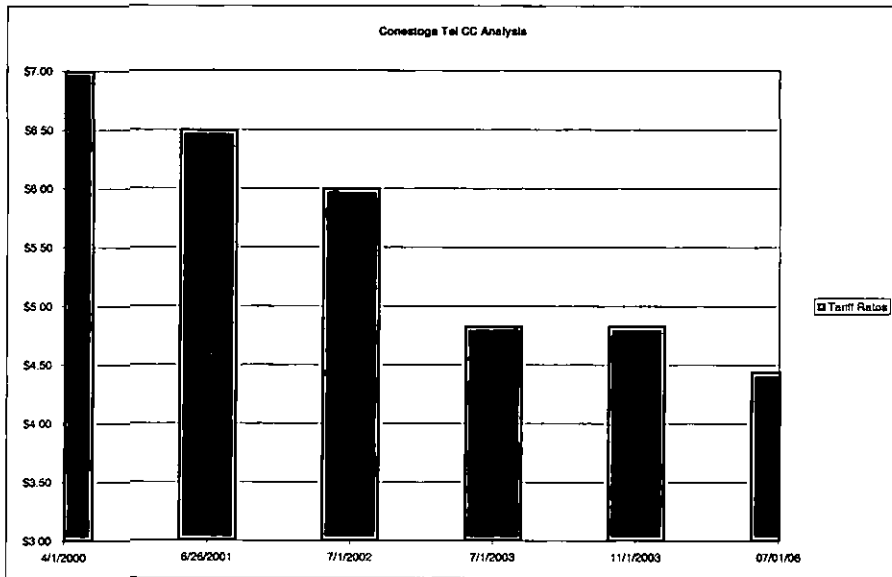
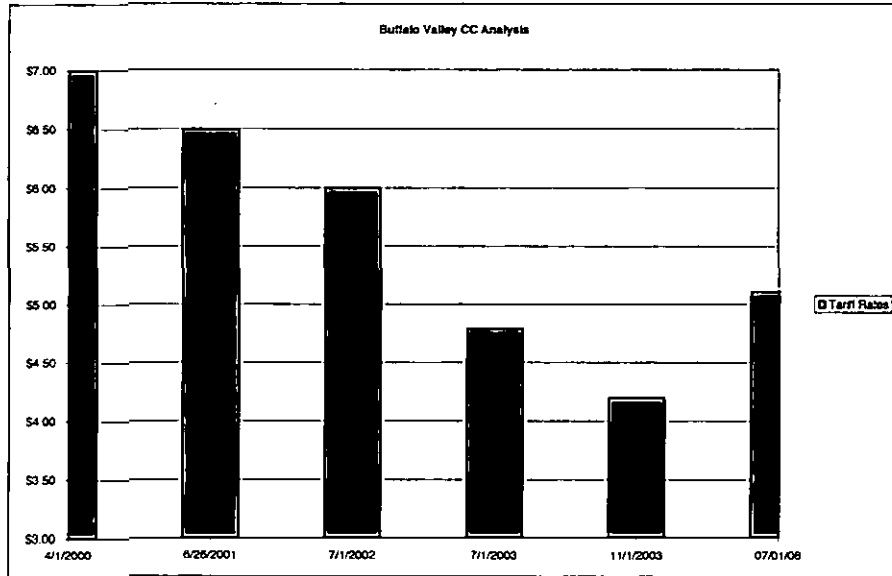
STATE ACCESS REDUCTIONS

CTT State Access Tariff PA PUC No. 11	4/1/2000	6/26/2001	7/1/2002	7/1/2003	11/1/2003	07/01/06	Chg from Global
Carrier Common Line	\$ 7.00	\$ 6.50	\$ 6.00	\$ 4.83	\$ 4.83	\$ 4.44	(\$2.56)
Entrance Facility - VG 2 Wire	\$ 35.09	\$ 26.94	\$ 23.18	\$ 23.18	\$ 23.18	\$ 23.18	(\$11.91)
Entrance Facility - VG 4 Wire	\$ 56.14	\$ 43.10	\$ 37.08	\$ 37.08	\$ 37.08	\$ 37.08	(\$19.06)
Entrance Facility - DS1	\$ 176.82	\$ 135.75	\$ 116.79	\$ 116.79	\$ 116.79	\$ 116.79	(\$60.03)
Entrance Facility - DS3	\$ 2,051.19	\$ 1,574.80	\$ 1,354.88	\$ 1,354.88	\$ 1,354.88	\$ 1,354.88	(\$696.31)
Direct Trunked Facility - VG	\$ 2.50	\$ 1.92	\$ 1.65	\$ 1.65	\$ 1.65	\$ 1.65	(\$0.85)
Direct Trunked Facility - DS1	\$ 19.14	\$ 14.69	\$ 12.64	\$ 12.64	\$ 12.64	\$ 12.64	(\$6.50)
Direct Trunked Facility - DS3	\$ 131.77	\$ 101.17	\$ 87.04	\$ 87.04	\$ 87.04	\$ 87.04	(\$44.73)
Direct Trunked Termination - VG	\$ 25.11	\$ 19.28	\$ 16.59	\$ 16.59	\$ 16.59	\$ 16.59	(\$8.52)
Direct Trunked Termination - DS1	\$ 94.38	\$ 72.46	\$ 62.34	\$ 62.34	\$ 62.34	\$ 62.34	(\$32.04)
Direct Trunked Termination - DS3	\$ 525.64	\$ 403.56	\$ 347.20	\$ 347.20	\$ 347.20	\$ 347.20	(\$178.44)
Multiplexing DS3 to DS1	\$ 474.31	\$ 364.15	\$ 313.30	\$ 313.30	\$ 313.30	\$ 313.30	(\$161.01)
Multiplexing DS1 to VG	\$ 183.12	\$ 140.59	\$ 120.96	\$ 120.96	\$ 120.96	\$ 120.96	(\$62.16)
Tandem Switching	\$ 0.002763	\$ 0.002121	\$ 0.001825	\$ 0.001825	\$ 0.001825	\$ 0.002787	\$0.000024
Tandem Switched Termination	\$ 0.001316	\$ 0.001010	\$ 0.000869	\$ 0.000869	\$ 0.000869	\$ 0.000869	(\$0.000447)
Tandem Switched Facility	\$ 0.000267	\$ 0.000205	\$ 0.000176	\$ 0.000176	\$ 0.000176	\$ 0.000176	(\$0.000091)
Transport Interconnection Charge	\$ 0.008242	\$ 0.006328	\$ 0.005444	\$ 0.005444	\$ 0.005444	\$ 0.005444	(\$0.002798)
Signaling Mileage Facility	\$ 3.96	\$ 3.96	\$ 3.96	\$ 3.96	\$ 3.96	\$ 3.96	\$0.00
Signaling Mileage Termination	\$ 39.79	\$ 39.79	\$ 39.79	\$ 39.79	\$ 39.79	\$ 39.79	\$0.00
Signaling Entrance Facility	\$ 64.75	\$ 64.75	\$ 64.75	\$ 64.75	\$ 64.75	\$ 64.75	\$0.00
STP Port	\$ 455.00	\$ 455.00	\$ 455.00	\$ 455.00	\$ 455.00	\$ 455.00	\$0.00
800 D/B Query - Basic	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$0.0000
800 D/B Query - Vertical Feature	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$0.0000
Local Switching	\$ 0.015431	\$ 0.011847	\$ 0.010193	\$ 0.010193	\$ 0.010193	\$ 0.017837	\$0.002406
Information Surcharge	\$ 0.000173	\$ 0.000133	\$ 0.000114	\$ 0.000114	\$ 0.000114	\$ 0.000114	(\$0.000059)
Total Composite TS per MOU	\$ 0.025429	\$ 0.019523	\$ 0.016796	\$ 0.016796	\$ 0.016796	\$ 0.024440	(\$0.000989)

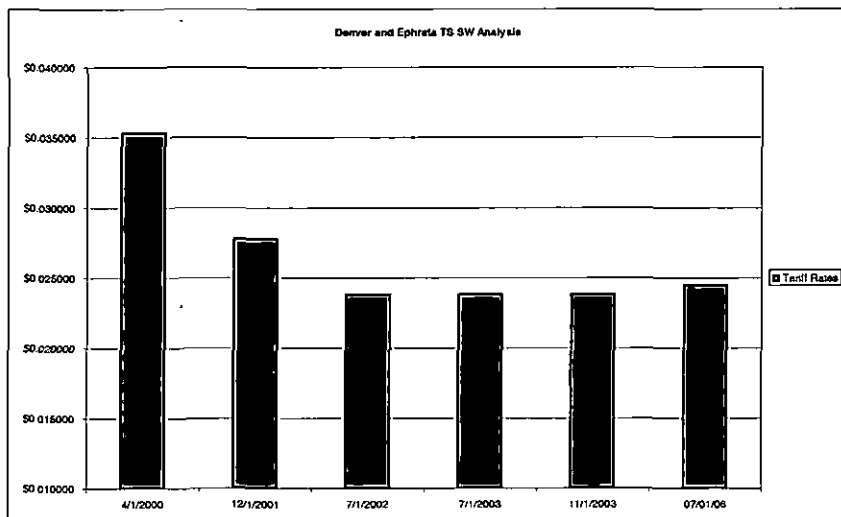
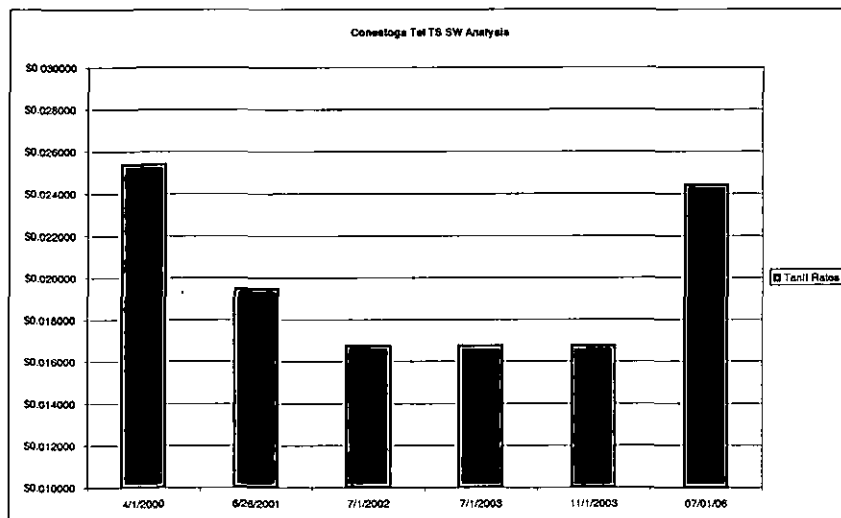
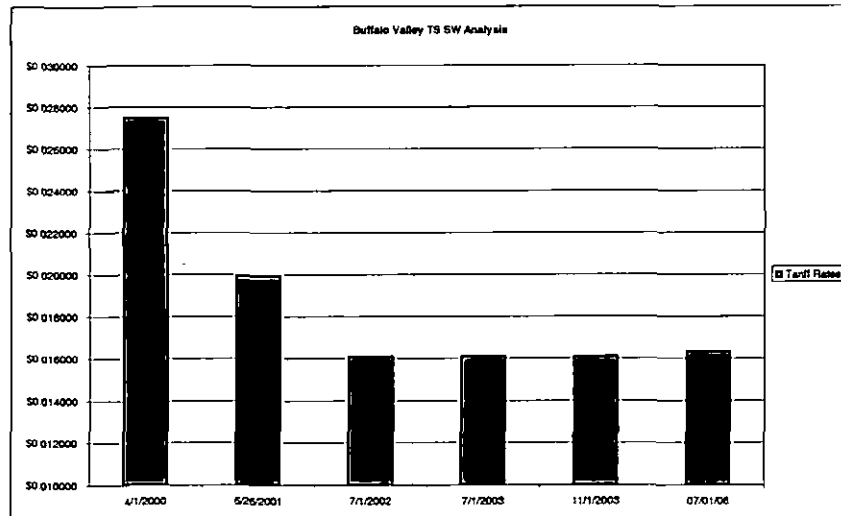
STATE ACCESS REDUCTIONS

D&E State Access Tariff PA PUC No. 16	4/1/2000	12/1/2001	7/1/2002	7/1/2003	11/1/2003	07/01/06	Chg from Global
Carrier Common Line	\$ 6.11	\$ 5.61	\$ 5.11	\$ 4.04	\$ 4.04	\$ 5.17	(\$0.94)
Entrance Facility - VG 2 Wire	\$ 35.09	\$ 27.32	\$ 23.47	\$ 23.47	\$ 23.47	\$ 23.47	(\$11.62)
Entrance Facility - VG 4 Wire	\$ 56.14	\$ 43.70	\$ 37.54	\$ 37.54	\$ 37.54	\$ 37.54	(\$18.60)
Entrance Facility - DS1	\$ 137.65	\$ 137.65	\$ 118.26	\$ 118.26	\$ 118.26	\$ 118.26	(\$19.39)
Entrance Facility - DS3	\$ 1,596.76	\$ 1,596.76	\$ 1,371.83	\$ 1,371.83	\$ 1,371.83	\$ 1,371.83	(\$224.93)
Direct Trunked Facility - VG	\$ 1.95	\$ 1.95	\$ 1.68	\$ 1.68	\$ 1.68	\$ 1.68	(\$0.27)
Direct Trunked Facility - DS1	\$ 14.90	\$ 14.90	\$ 12.80	\$ 12.80	\$ 12.80	\$ 12.80	(\$2.10)
Direct Trunked Facility - DS3	\$ 102.58	\$ 102.58	\$ 88.13	\$ 88.13	\$ 88.13	\$ 88.13	(\$14.45)
Direct Trunked Termination - VG	\$ 19.55	\$ 19.55	\$ 16.80	\$ 16.80	\$ 16.80	\$ 16.80	(\$2.75)
Direct Trunked Termination - DS1	\$ 73.47	\$ 73.47	\$ 63.12	\$ 63.12	\$ 63.12	\$ 63.12	(\$10.35)
Direct Trunked Termination - DS3	\$ 409.19	\$ 409.19	\$ 351.55	\$ 351.55	\$ 351.55	\$ 351.55	(\$57.64)
Multiplexing DS3 to DS1	\$ 369.23	\$ 369.23	\$ 317.22	\$ 317.22	\$ 317.22	\$ 317.22	(\$52.01)
Multiplexing DS1 to VG	\$ 142.55	\$ 142.55	\$ 122.47	\$ 122.47	\$ 122.47	\$ 122.47	(\$20.08)
Tandem Switching	\$ 0.002151	\$ 0.002151	\$ 0.001848	\$ 0.001848	\$ 0.001848	\$ 0.002787	\$0.000636
Tandem Switched Termination	\$ 0.001024	\$ 0.001024	\$ 0.000880	\$ 0.000880	\$ 0.000880	\$ 0.000880	(\$0.000144)
Tandem Switched Facility	\$ 0.000208	\$ 0.000208	\$ 0.000179	\$ 0.000179	\$ 0.000179	\$ 0.000179	(\$0.000029)
Transport Interconnection Charge	\$ 0.008242	\$ 0.006416	\$ 0.005512	\$ 0.005512	\$ 0.005512	\$ 0.005512	(\$0.002730)
Signaling Mileage Facility	\$ 3.96	\$ 3.96	\$ 3.96	\$ 3.96	\$ 3.96	\$ 3.96	\$0.00
Signaling Mileage Termination	\$ 39.79	\$ 39.79	\$ 39.79	\$ 39.79	\$ 39.79	\$ 39.79	\$0.00
Signaling Entrance Facility	\$ 64.75	\$ 64.75	\$ 64.75	\$ 64.75	\$ 64.75	\$ 64.75	\$0.00
STP Port	\$ 455.00	\$ 455.00	\$ 455.00	\$ 455.00	\$ 455.00	\$ 455.00	\$0.00
800 D/B Query - Basic	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$ 0.0048	\$0.0000
800 D/B Query - Vertical Feature	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$ 0.0054	\$0.0000
Local Switching	\$ 0.025719	\$ 0.020021	\$ 0.017201	\$ 0.017201	\$ 0.017201	\$ 0.017837	(\$0.007882)
Information Surcharge	\$ 0.000173	\$ 0.000135	\$ 0.000116	\$ 0.000116	\$ 0.000116	\$ 0.000116	(\$0.000057)
Total Composite TS per MOU	\$ 0.035366	\$ 0.027804	\$ 0.023888	\$ 0.023888	\$ 0.023888	\$ 0.024524	(\$0.010842)

CC ANALYSIS



TS ANALYSIS



DIAL TONE INCREASES

BVT Local Tariff PA PUC No. 7

	4/1/2000	06/26/01	07/01/02	07/01/02	07/01/03	11/01/03	10/01/04	08/01/05	07/01/06
Res. Dialtone	\$ 7.04	\$ 9.54	\$ 9.65	\$ 11.15	\$ 12.65	\$ 13.50	\$ 13.32	\$ 14.20	\$ 14.50
Bus. Dialtone	\$ 14.00	\$ 15.00	\$ 15.11	\$ 16.11	\$ 17.11	\$ 17.11	\$ 16.92	\$ 17.80	\$ 18.10

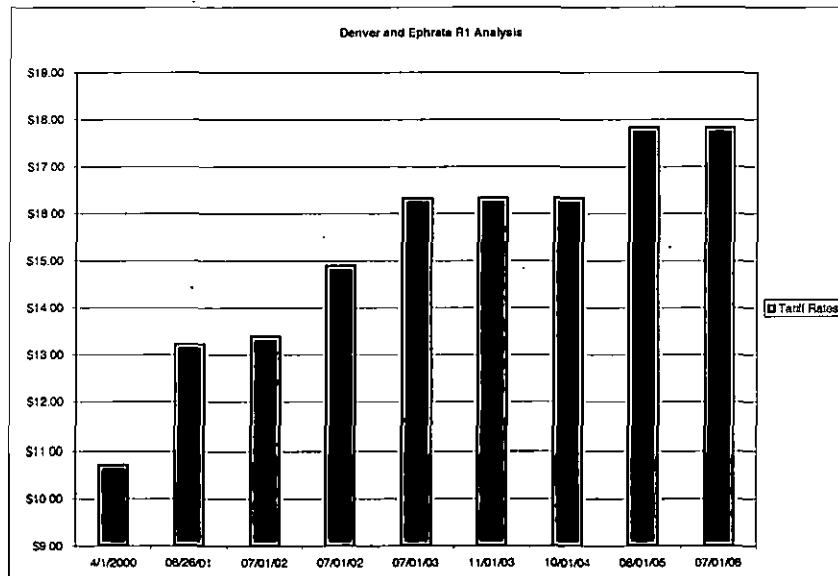
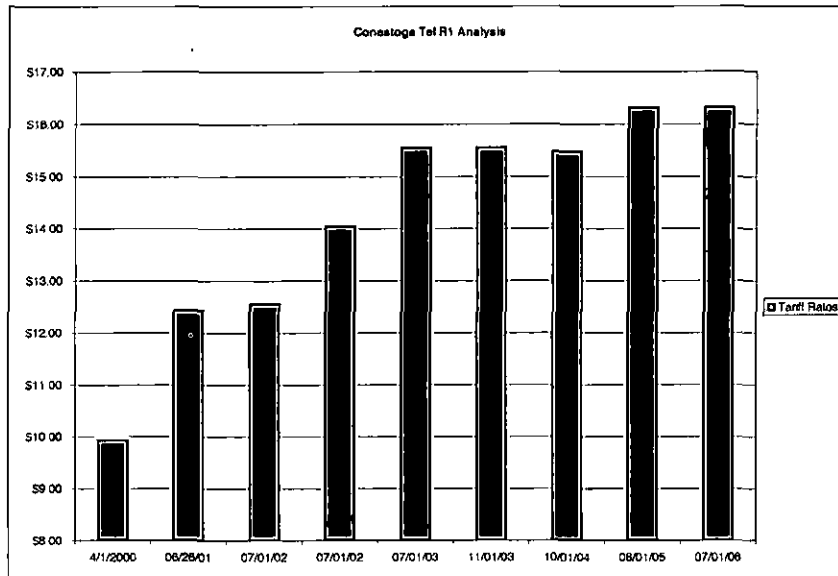
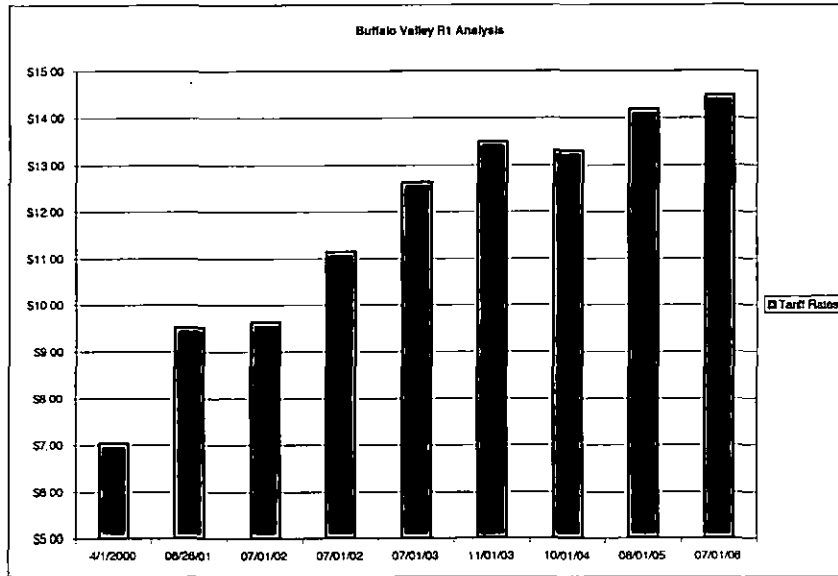
CTT Local Tariff PA PUC No. 10

	4/1/2000	06/26/01	07/01/02	07/01/02	07/01/03	11/01/03	10/01/04	08/01/05	07/01/06
Rate Band 1									
Res. Dialtone	\$ 5.41	\$ 7.91	\$ 8.03	\$ 9.53	\$ 11.03	\$ 11.03	\$ 10.95	\$ 11.79	\$ 11.79
Bus. Dialtone	\$ 10.33	\$ 11.33	\$ 11.45	\$ 12.45	\$ 13.45	\$ 13.45	\$ 13.37	\$ 14.21	\$ 14.21
Rate Band 2									
Res. Dialtone	\$ 6.08	\$ 8.58	\$ 8.70	\$ 10.20	\$ 11.70	\$ 11.70	\$ 11.62	\$ 12.46	\$ 12.46
Bus. Dialtone	\$ 11.67	\$ 12.67	\$ 12.79	\$ 13.79	\$ 14.79	\$ 14.79	\$ 14.71	\$ 15.55	\$ 15.55
Rate Band 3									
Res. Dialtone	\$ 6.89	\$ 9.39	\$ 9.51	\$ 11.01	\$ 12.51	\$ 12.51	\$ 12.43	\$ 13.27	\$ 13.27
Bus. Dialtone	\$ 13.19	\$ 14.19	\$ 14.31	\$ 15.31	\$ 16.31	\$ 16.31	\$ 16.23	\$ 17.07	\$ 17.07
Rate Band 4									
Res. Dialtone	\$ 7.79	\$ 10.29	\$ 10.41	\$ 11.91	\$ 13.41	\$ 13.41	\$ 13.33	\$ 14.17	\$ 14.17
Bus. Dialtone	\$ 14.90	\$ 15.90	\$ 16.02	\$ 17.02	\$ 18.02	\$ 18.02	\$ 17.94	\$ 18.78	\$ 18.78
Rate Band 5									
Res. Dialtone	\$ 8.80	\$ 11.30	\$ 11.42	\$ 12.92	\$ 14.42	\$ 14.42	\$ 14.34	\$ 15.18	\$ 15.18
Bus. Dialtone	\$ 16.83	\$ 17.83	\$ 17.95	\$ 18.95	\$ 19.95	\$ 19.95	\$ 19.87	\$ 20.71	\$ 20.71
Rate Band 6									
Res. Dialtone	\$ 9.94	\$ 12.44	\$ 12.56	\$ 14.06	\$ 15.56	\$ 15.56	\$ 15.48	\$ 16.32	\$ 16.32
Bus. Dialtone	\$ 19.00	\$ 20.00	\$ 20.12	\$ 21.12	\$ 22.12	\$ 22.12	\$ 22.04	\$ 22.88	\$ 22.88

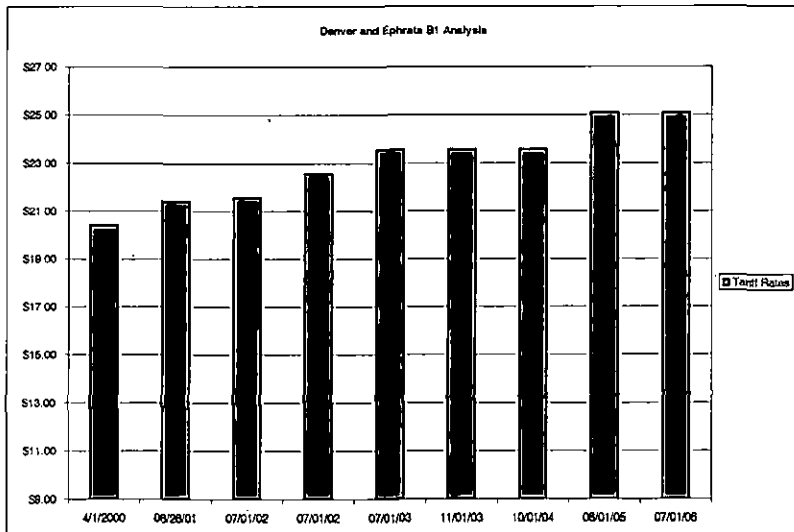
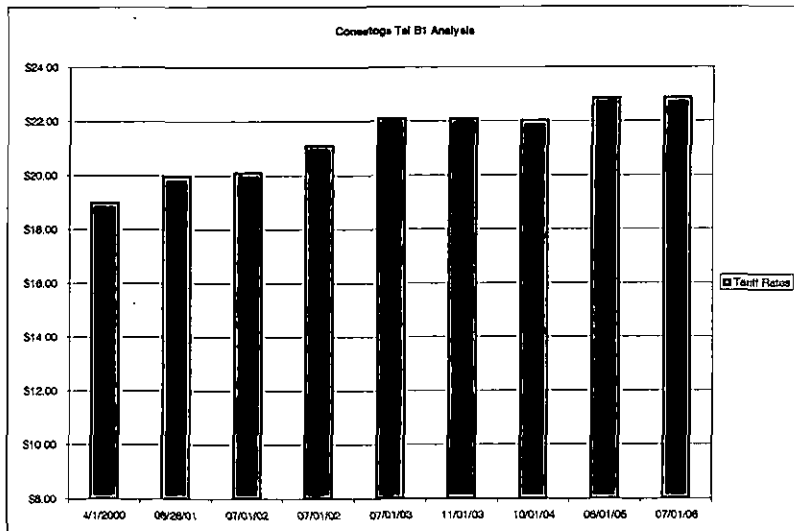
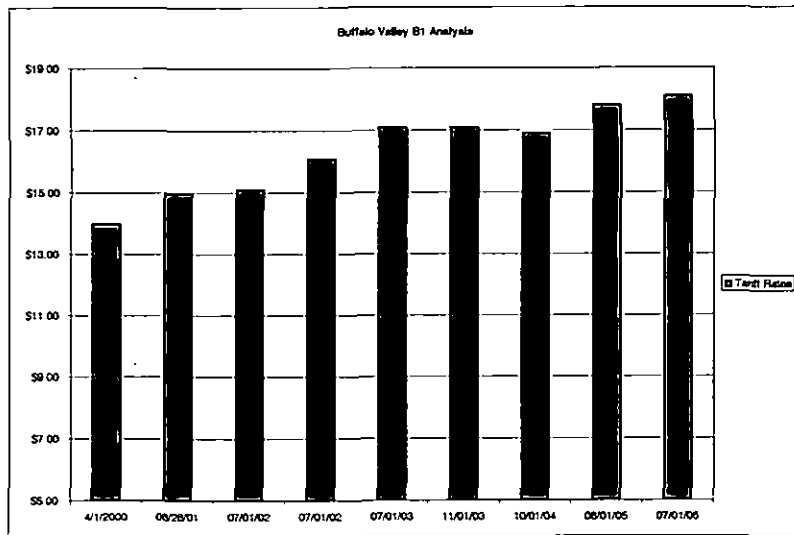
D&E Local Tariff PA PUC No. 15

	4/1/2000	12/1/2001	07/01/02	07/01/02	07/01/03	11/01/03	10/01/04	08/01/05	07/01/06
Rate Band 1									
Res. 1P Dialtone	\$ 5.64	\$ 8.14	\$ 8.30	\$ 9.80	\$ 11.24	\$ 11.24	\$ 11.24	\$ 12.75	\$ 12.75
Bus. Dialtone	\$ 10.78	\$ 11.78	\$ 11.94	\$ 12.94	\$ 13.94	\$ 13.94	\$ 13.94	\$ 15.45	\$ 15.45
Rate Band 2									
Res. 1P Dialtone	\$ 6.57	\$ 9.07	\$ 9.23	\$ 10.73	\$ 12.17	\$ 12.17	\$ 12.17	\$ 13.68	\$ 13.68
Bus. Dialtone	\$ 12.53	\$ 13.53	\$ 13.69	\$ 14.69	\$ 15.69	\$ 15.69	\$ 15.69	\$ 17.20	\$ 17.20
Rate Band 3									
Res. 1P Dialtone	\$ 7.55	\$ 10.05	\$ 10.21	\$ 11.71	\$ 13.15	\$ 13.15	\$ 13.15	\$ 14.66	\$ 14.66
Bus. Dialtone	\$ 14.38	\$ 15.38	\$ 15.54	\$ 16.54	\$ 17.54	\$ 17.54	\$ 17.54	\$ 19.05	\$ 19.05
Rate Band 4									
Res. 1P Dialtone	\$ 8.58	\$ 11.08	\$ 11.24	\$ 12.74	\$ 14.18	\$ 14.18	\$ 14.18	\$ 15.69	\$ 15.69
Bus. Dialtone	\$ 16.38	\$ 17.38	\$ 17.54	\$ 18.54	\$ 19.54	\$ 19.54	\$ 19.54	\$ 21.05	\$ 21.05
Rate Band 5									
Res. 1P Dialtone	\$ 9.66	\$ 12.16	\$ 12.32	\$ 13.82	\$ 15.26	\$ 15.26	\$ 15.26	\$ 16.77	\$ 16.77
Bus. Dialtone	\$ 18.38	\$ 19.38	\$ 19.54	\$ 20.54	\$ 21.54	\$ 21.54	\$ 21.54	\$ 23.05	\$ 23.05
Rate Band 6									
Res. 1P Dialtone	\$ 10.74	\$ 13.24	\$ 13.40	\$ 14.90	\$ 16.34	\$ 16.34	\$ 16.34	\$ 17.85	\$ 17.85
Bus. Dialtone	\$ 20.43	\$ 21.43	\$ 21.59	\$ 22.59	\$ 23.59	\$ 23.59	\$ 23.59	\$ 25.10	\$ 25.10
Rate Band 7									
Res. 1P Dialtone	\$ 11.82	\$ 14.32	\$ 14.48	\$ 15.98	\$ 17.42	\$ 17.42	\$ 17.42	\$ 18.93	\$ 18.93
Bus. Dialtone	\$ 22.53	\$ 23.53	\$ 23.69	\$ 24.69	\$ 25.69	\$ 25.69	\$ 25.69	\$ 27.20	\$ 27.20

R-1 ANALYSIS



B-1 ANALYSIS



D&E EXHIBIT 5

PROPRIETARY

D&E EXHIBIT 6

PROPRIETARY

RECEIVED

JAN 22 2007

**PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU**

EXHIBIT 1

DOCKETED
JUN 18 2007

**DOCUMENT
FOLDER**

P-00981428 F/000

HBG

1-17-07 hrg

APPENDIX II

SMALL COMPANY UNIVERSAL SERVICE FUND SETTLEMENT

CONTENTS

SETTLEMENT

Appendix A -- Terms And Conditions Of Universal Service Fund

EXHIBIT 1 -- Spreadsheets

Appendix B-- Revised Universal Service Fund Regulations

SETTLEMENT

A. The Need for Resolution

1. One of the major issues presented at Docket Nos. I-00940035 and I-00960066 has been the identification of any subsidies to support Universal Service, and whether and how to move and/or supplant any existing implicit subsidies in local exchange carrier access and toll revenue streams.

2. One of the fundamental issues in the Universal Service debate has been the development of a cost model. The Commission has been investigating several cost proxy models that various parties have proposed for use in establishing a Fund. However, to date, a cost proxy model has not been perfected to the point of accurately reflecting the cost of providing Universal Service for any company, but particularly so for the smaller and rural companies. Moreover, for the smaller, rural telephone companies, the FCC has stated that a four year transition period is required to investigate properly the issue of Universal Service cost development.⁷⁹

3. In the Access Charge Investigation at Docket No. I-00960066, many of the parties have contended that carrier access charges are one of the sources of subsidy for basic universal services, and proposals have been made to reduce this subsidy and/or make it "explicit."

⁷⁹In the Matter of Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Report and Order released May 8, 1997.

4. From the standpoint of the smaller incumbent local exchange carriers, this Settlement Agreement proposes a means to reduce access and toll rates for the benefit of the end-user customer and in order to encourage greater toll competition, while at the same time continuing to maintain the affordability of local service rates. Pennsylvania can and should take steps toward implementing access and toll rate reform and begin addressing subsidy levels now. The settlement proposal advanced herein will take those steps without the need to become embroiled prematurely in the debate over hypothetical costing models and bring to an end the costly litigation in the Universal Service and Access Charge investigation dockets.

B. Summary of Terms

5. This portion of the Settlement Agreement proposes to resolve all of the open issues applicable to the Small ILECs⁸⁰ and Bell Atlantic-Pennsylvania ("BA-PA"), at Docket Nos. I-00940035, L-00950105, I-00940034 and I-00960066, in a pragmatic, but equitable, manner that provides benefits to all

⁸⁰The Small ILECs include ALLTEL Pennsylvania, Inc., Armstrong Telephone Company - PA, Armstrong Telephone Company - North, The Bentleyville Telephone Company, Buffalo Valley Telephone Company, Citizens Telephone Company of Kecksburg, Citizens Communications Services Company, Commonwealth Telephone Company, Conestoga Telephone and Telegraph Company, Denver and Ephrata Telephone and Telegraph Company, Deposit Telephone Company, Frontier Communications of Breezewood, Inc., Frontier Communications of Canton, Inc., Frontier Communications of Lakewood, Inc., Frontier Communications of Oswayo River, Inc., Frontier Communications of Pennsylvania, Inc., The Hancock Telephone Company, Hickory Telephone Company, Ironton Telephone Company, Lackawaxen Telephone Company, Laurel Highland Telephone Company, Mahanoy & Mahantango Telephone Co., Marianna & Scenery Hill Telephone Company, The North-Eastern PA Telephone Company, North Penn Telephone Company, North Pittsburgh Telephone Company, Palmerton Telephone Company, Pennsylvania Telephone Company, Pymatuning Independent Telephone Company, South Canaan Telephone Company, Sugar Valley Telephone Company, Venus Telephone Corporation and Yukon Waltz Telephone Company.

involved parties and promotes the public interest. A general summary is set forth below.⁸¹

a) A Universal Service Fund of approximately \$20.5 million will be established. The effective date of the Fund is July 1, 1999.

b) All telecommunications service providers (excluding wireless carriers) will contribute to the Fund on the basis of their intrastate end-user telecommunications revenues. The Small ILECs and BA-PA will not implement an end-user surcharge to recover their Fund contributions.

c) All Small ILECs, which include all ILECs other than Bell Atlantic, Sprint and GTE, will be Fund Recipients. The Fund will be used to fund the immediate rate rebalancing needs of these smaller, rural local exchange carriers.

d) The Small ILECs will restructure and reduce their access and toll rates, as follows:

1) Intrastate traffic sensitive switched access rates and structure (including local transport restructure) will be converted to interstate switched access rates and structure in effect on July 1, 1998.

2) The carrier common line ("CCL") charge of the Small ILECs will be restructured as a flat-rate Carrier Charge ("CC") and reduced to an

⁸¹The precise terms and conditions of the settlement are set forth in Section C hereto and in Appendix A which is attached hereto. The terms and conditions set forth in Section C and Appendix A govern in the event of any ambiguity or conflict with this summary.

intrastate rate of approximately \$7.00 per line.⁸² Further reductions are possible in the first year of the Fund if needed to pass through to ratepayers the full benefit realized from the Fund as well as reductions in terminating access costs.

3) The Small ILECs also will be given the opportunity to reduce their toll rates to an average rate not lower than \$.09 per minute.⁸³

4) The Small ILECs also will be permitted to increase their residential one-party basic, local rates up to an average monthly charge of at least \$10.83, to the extent necessary to offset the reduced toll rates. This change affects only eight companies. Any excess needed to fund the toll rate reduction is designed to come from the Fund.⁸⁴

5) Small ILECs with monthly residential one-party basic, local rates above \$16.00 at the time the Fund is implemented will provide a Universal Service credit in an amount that will effectively reduce the rate to \$16.00 with their business rates receiving a proportionate credit. See Appendix A, Exhibit 1, page 4.

6) If the Fund is permitted to be dissolved with no alternative funding established, residential and business Universal Service Credits

⁸²This tariff rate change, and all others described in this Settlement Agreement, shall be made as compliance filings pursuant to any Pa. P.U.C. Order approving this Settlement Agreement and shall be permitted to be effective on ten (10) days notice.

⁸³There is no expectation, express or implied, that a toll rate of \$.09 per minute will be sufficient to meet competition throughout the life of the Settlement Plan. In fact, numerous interexchange carrier toll plans are substantially below \$.09. However, \$.09 was chosen as appropriate to the size of the Fund. Nothing in this Settlement Agreement or Appendix A precludes a Small ILEC from proposing lower toll rates in individual proceedings.

⁸⁴Nothing in this Settlement Agreement or Appendix A precludes any local exchange carrier from proposing greater local exchange rates in individual proceedings. Further reductions to a level not below \$.09 will be provided by the Fund and ITORP expense savings.

will be eliminated, and toll and access rates will immediately return, at a company's option, to their pre-funded levels pursuant to a compliance filing.

6. Nothing in this Settlement Agreement or Appendix A precludes any Party from seeking rate increases or decreases not specifically outlined herein.

7. Approval of the rate structure changes proposed in this Settlement Agreement will be a dramatic first step by the Pennsylvania Public Utility Commission in undertaking Universal Service Funding and access charge reform for the Small ILECs and BA-PA. The changes proposed are not the end of the road, but a strong beginning which is needed to address these issues.

8. The collection and distribution of the Fund and the uses for which it is to be applied are set forth in Appendix A hereto.

9. The participants to this Settlement Agreement estimate that the access charges of Small ILECs will be reduced by over \$15 million. This is a significant reduction in access service charges which have historically generated a subsidy to local service and which have not been materially reduced since originally established over ten years ago. Moreover, if the reductions are passed through to end user customers by the interexchange carriers, as they have stipulated in this Settlement Agreement, the reductions will result in significant customer savings.

10. The Small ILEC toll rates, which have also been a source of subsidy, will be reduced by an estimate of approximately \$10.6 million annually, thereby producing additional customer dividends.

C. Specific Terms and Conditions

11. This Settlement Agreement proposes to resolve the aforementioned pending dockets from the standpoint of the Small ILECs and BA-PA on the following terms and conditions.

a) A Universal Service Fund will be established on the terms and conditions described in full in Appendix A and Appendix B hereto, which is incorporated herein by reference.

b) The Commission will issue the proposed regulations for implementation and administration of the Universal Service Fund, in the form set forth in Appendix B hereto, which is incorporated herein by reference.

c) In addition to the rate changes described in Appendix A that are applicable to the Small ILECs, Bell Atlantic and the Small ILECs shall be permitted to restructure their intrastate CCLC as a flat-rate Carrier Charge ("CC") to be recovered from all toll carriers on a proportional minutes of use basis. The CC will be implemented on a revenue neutral basis for all Small ILECs in a manner similar, but not identical, to that proposed by Sprint in its Main Brief in the Access Charge Investigation,⁸⁵ including the imputation into the revenue pool of the CCL revenues associated with the Small ILECs and BA-PA toll minutes

and the allocation of recovery on the basis of all originating and terminating minutes. Such rate changes will be filed as compliance filings pursuant to the Commission's Order approving this Settlement Agreement to be effective July 1, 1999. Consistent with the provisions of the Public Utility Code, the Commission shall permit such tariffs to become effective or, should a complaint be filed or investigation instituted, permit the tariffs to go into effect subject to the resolution of such complaint or investigation.

d) The Small ILECs and BA-PA shall be entitled to recover intraLATA presubscription costs from the interexchange carriers pursuant to the Commission's Order at I-00940034, entered on December 14, 1995. The direct, incremental costs associated with implementing presubscription shall be recovered, subject to an annual true up/down, from the interexchange carriers operating in Pennsylvania over a three year period based upon each interexchange carrier's share of total originating and terminating intrastate toll minutes of use.

e) During the term of this Agreement, the Small ILECs shall not be required to pass any imputation test, unless all interexchange carriers operating in Pennsylvania agree or are lawfully required to comply with the same exact imputation test as may be imposed on the local exchange carriers.

f) The Small ILECs which have filed Chapter 30 Plans prior to the date of this Settlement Agreement which Plans contain provisions relating to the cost of universal service may provide embedded cost data in support of any

⁸⁵Specifically, this proposal is solely limited to restructuring the CCLC, and does not include any NTS cost recovery from existing TS rates. In addition, no intrastate SLC will be implemented. See Sprint/United

tariff rate changes permitted under the terms of such Plans. Further, with respect to the Small ILECs which have Chapter 30 Plans pending before the Commission at the date of this Settlement Agreement, the intrastate access charges to be established pursuant to the approval of this Settlement Agreement shall be considered just and reasonable rates for the purpose of resolving such Plans.

g) The Commission will initiate a proceeding on or about January 2, 2003, to determine how the aforesaid fund/pool shall be reduced or otherwise modified. If the Fund is permitted to be dissolved with no alternative funding established, residential, business, toll and access rates will immediately return, at the companies' option, to their pre-funded levels pursuant to a compliance filing.

h) This Settlement Agreement completely resolves all of the issues in Docket I-00940035 (Universal Service Investigation); Docket L-00950105 (Universal Service Rulemaking); and Docket I-00940034 (Presubscription Cost Recovery) from the standpoint of BA-PA and the Small ILECs. No cost proxy model will be selected by the Commission for submission to the Federal Communications Commission for use in connection with federal universal service funding. Nothing herein shall prevent the Commission from generally investigating costing methodologies; provided, however, that the Universal Service Fund established hereunder shall be unaffected thereby.

i) This Settlement completely resolves all of the issues in Docket I-00960066 (Access Charges), including all issues of payphone subsidies and the removal thereof, where applicable, from access charges for BA-PA and the Small ILECs. In all respects, the Commission will terminate this docket and mark it closed upon final approval of this Settlement.

APPENDIX A
TERMS AND CONDITIONS OF UNIVERSAL SERVICE FUND

I. SIZE AND ASSESSMENT OF UNIVERSAL SERVICE FUND CONTRIBUTION

A. All telecommunications service providers (excluding wireless carriers) will contribute to the Universal Service Fund ("Fund").

B. Bell Atlantic-Pa., Inc.'s ("BA-PA") contribution share to the Fund shall be capped at \$12 million per year to support the funding requirements of the participants.

C. The total size of the Fund and the contributions of other telecommunications providers shall be calculated as follows:

1. The total size of the Fund in the initial period on an annual basis will be equal to \$12.0 million divided by BA-PA's percentage of the total intrastate (Pennsylvania) end-user telecommunications revenues for the preceding calendar year (BA-PA assessment percentage),⁸⁶ as shown:

$$\begin{aligned} 1999 \text{ Fund} &= \$12.0 \text{ million} / \text{BA-PA assessment percentage} \\ &= \$12.0 \text{ million} / 56.6\%^{87} \\ &= \$21.2 \text{ million} \end{aligned}$$

2. Each year of the subsequent calendar years, beginning with the Year 2000, the total size of the Fund shall be increased by first calculating the

⁸⁶Initially, until such time as the total intrastate end-user telecommunications revenues are determined by the fund administrator, total gross intrastate revenues as reported to the Commission pursuant to 66 Pa. C.S.A. § 510 may be used to determine BA-PA's assessment percentage and all telecommunication service providers' contributions to the Fund.

size of the Fund as described above, and then by increasing the total amount for that year by the average annual access line growth rate for the Fund participants (compounded annually). For example:

2000 Fund	=	\$12 million/BA-PA assessment percentage
	=	\$12 million/56.6% (assumes no change in assessment rate)
	=	\$21.2 million x 1998 access line growth rate
	=	\$21.2 million x 1.03 (assumes 3% growth)
	=	\$21.8 million.

Each Fund Recipient's share shall be adjusted annually to reflect its annual actual access line growth.

3. The contributing share of each telecommunications service provider except BA-PA (BA-PA's share is capped at \$12M) will be based on its respective pro rata share of total intrastate end-user telecommunications revenues,⁸⁸ so that the total contributions equal the total size of the Fund.

4. All telecommunications service providers will be required to file statements annually with the Commission specifying their total end-user telecommunications revenues for purposes of calculating the size of the Fund and each telecommunications service provider's allocated contribution.

D. No credits or offsets, either explicit or implicit, will be provided to any telecommunications service provider's contribution based upon access charges (including the carrier charge) paid by the contributor.

⁸⁷This is BA-PA's 1998 PUC assessment percentage, used for illustrative purposes.

⁸⁸End-user revenues expressly do not include revenues from access charges, toll resale, local service resale, unbundled network elements or other activities which are essentially wholesale in nature.

E. BA-PA will not implement a customer surcharge to recover its contribution to the Fund. BA-PA shall be permitted to use any negative Price Change Opportunity(ies) from its Alternative Regulatory Plan to support its funding contribution.

F. No Small ILEC may request an end-user surcharge to recover its respective contribution obligation to the Fund.

G. The size of Fund will be recalculated annually and is expected to expand/contract for various reasons, including increases or decreases to non-BA-PA telecommunications service provider end-user revenues on a relative basis.

II. DISTRIBUTION OF THE FUND

A. All incumbent local exchange carriers operating in Pennsylvania, with the exception of Bell Atlantic, Sprint and GTE, shall be recipients of the Fund ("Fund Recipients").

B. All revenues received from the Fund, after the deduction therefrom of any contribution made by a Fund Recipient to the Fund, shall be used to rebalance, on a revenue neutral basis, the rates/revenues derived from access and/or other services according to the rules set forth herein.

C. The fund recipients will implement tariff rate changes as follows:

1. First, each company will lower toll rates to an average level of \$.11 per minute level. Local residential rates will be increased to an average of \$10.83 per line. Any residual shortage will be recovered from the Fund.

2. Second, companies with R-1 rates above \$16.00 at the time the Fund is implemented will effectively reduce R-1 rates to \$16.00 with business rates being reduced by a proportionate amount through the issuance of a monthly credit on the customer bills. This reduction is covered by the Fund. If the Fund is permitted to be dissolved with no alternative funding established, residential and business Universal Service Credits will be eliminated, and toll and access rates will immediately return, at the companies' option, to their pre-funded levels pursuant to a compliance filing.

3. Third, each company will develop their current intrastate carrier common line ("CCL") revenue amount. This amount shall include CCL revenue for IXC billed interLATA and intraLATA minutes, terminating ITORP minutes and the imputation of CCL revenues associated with the company's originating toll minutes of use.

4. Fourth, each company will mirror their interstate traffic sensitive ("TS") rates and structure (including local transport restructure) which were effective as of July 1, 1998 for intrastate purposes. If this causes an increase in rates, then the CCL revenue amount from the previous step shall be reduced accordingly.

5. Fifth, each company will reduce the current CCL revenue amount (reduced by the TS increase, if applicable) to the equivalent of approximately \$7.00 per month per access line.

6. Sixth, each company will convert recovery of the CCL component to a flat-rate Carrier Charge ("CC") recovered from all toll carriers on a proportional minutes of use basis. The CC will be implemented on a revenue neutral basis in a manner similar, but not identical⁸⁹ to that proposed by Sprint in its Main Brief in the Access Charge Investigation, including the imputation into the revenue pool of the CCL revenues associated with the company's toll minutes and the allocation of recovery on the basis of all originating and terminating minutes. Minutes (i.e., market share) shall be recalculated on a monthly basis.

7. Seventh, each company will flow through the benefits derived from the Fund and ITORP expense decreases by lowering intraLATA toll rates. An average price floor of \$.09 per minute will be established.

8. Eighth, Plan benefits that remain after lowering toll rates will first be applied to any shortfall in the size of the Fund that may exist. Any remaining benefits, at a company's option, will be used to either reduce the CC or reduce the amount to be received from the Fund.

D

⁸⁹Specifically, the companies will not remove any non-traffic sensitive ^{cost} recovery from existing TS rates. Secondly, an intrastate SLC is not implemented hereby. See Sprint/United Main Brief at 7-10.

III. IMPLEMENTATION

A. The Fund Recipients agree to the distribution amounts as shown in Exhibit 1, page 1. The amounts to be distributed to the Fund Recipients are fixed at the amount shown plus the adjustment for the actual company-specific percentage access line growth for the term of the agreement.

B. Each Fund Recipient shall file the appropriate tariffs to implement the rate changes described, effective on ten (10) days notice, in the form of a compliance filing pursuant to the Commission Order approving the Fund.

1. Such tariff filings shall include a demonstration of revenue neutrality for the tariff filing consistent with the terms of this Appendix A.

2. Tariffs shall be filed to be effective July 1, 1999, coincident with the effective date of the Fund.

3. The Commission shall approve those tariffs or, should a complaint be filed or investigation instituted, permit the tariffs to go into effect subject to the resolution of such complaint or investigation.

4. Customers will be notified of these rate changes by bill insert/message.

IV. OTHER

A. All Fund Recipients listed in Exhibit 1 and all other ILECs who are parties to the Settlement Agreement have been designated as eligible telecommunications carriers under the Telecommunications Act of 1996 to receive universal service support under the requirements of both the FCC and this Commission.⁹⁰

B. The Fund shall commence on July 1, 1999 and operate until such time as the FCC finally determines (including resolution of any appeals), and this Commission adopts, a cost method to be employed for Universal Service purposes by the Small ILECs, whichever occurs sooner. Further, the Commission will initiate a proceeding on or about January 2, 2003, to consider how the fund/pool will be reduced or otherwise modified.

⁹⁰ All Fund Recipients and BA-PA have filed for designation as eligible telecommunications carriers. These local exchange carriers are each pre-designated as an eligible telecommunications carrier under 52 Pa. Code §63.145 or any successor provision when it may become effective. See, Appendix B hereto.

Summary - Estimated Size Of PA USF Fund

COMPANY NAMES	TS App Rate Reduction Recovered Thru USF see p. 6	CCL Support Reduction Recovered Thru USF see pp. 7&8	Toll Rate Reduction Recovered Thru USF see pp. 2&3	Local Rate R1 cap Reduction Recovered Thru USF see p. 4	Annual USF Amount Before adjustments	Adjustment to properly size Fund see App.A, II,C(8)	Annual USF Amount After adjustments
ALLTEL	\$5,046,750	\$3,661,776	\$0	\$0	\$8,708,526	(\$738,157)	\$7,970,369
Armstrong North	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Armstrong PA	\$0	\$247,414	\$0	\$0	\$247,414	(\$60,410)	\$187,004
Bentleyville	\$0	\$393,398	\$0	\$0	\$393,398	(\$56,585)	\$336,813
Buffalo Valley	\$0	\$590,504	\$0	\$0	\$590,504	(\$19,215)	\$571,289
Citizens Communications	\$64,671	\$11,617	\$31,678	\$0	\$107,965	\$0	\$107,965
Citizens of Kecksburg	\$0	\$21,725	\$0	\$0	\$21,725	(\$19,326)	\$2,399
Commonwealth	\$0	\$480,694	\$0	\$0	\$480,694	\$0	\$480,694
Conestoga	\$0	\$1,333,963	\$0	\$0	\$1,333,963	(\$1,689)	\$1,332,275
Denver & Ephrata	\$0	\$586,274	\$0	\$0	\$586,274	\$0	\$586,274
Frontier Breezewood	\$14,599	\$67,730	\$25,232	\$0	\$107,561	\$0	\$107,561
Frontier Canton	\$84,867	\$0	\$74,414	\$0	\$159,281	\$0	\$159,281
Frontier Lakewood	\$3,260	\$94,415	\$13,209	\$0	\$110,884	(\$2,569)	\$108,314
Frontier Oswayo	\$77,069	\$5,565	\$0	\$0	\$82,634	(\$2,777)	\$79,857
Frontier PA	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Hickory	\$0	\$59,972	\$37,849	\$0	\$97,821	\$0	\$97,821
Ironton	\$0	\$0	\$59,757	\$0	\$59,757	(\$3,224)	\$56,533
Lackawaxen	\$0	\$100,574	\$0	\$0	\$100,574	(\$2,907)	\$97,667
Laurel Highland	\$0	\$231,882	\$53,277	\$0	\$285,159	\$0	\$285,159
Mahanoy & Mahantango	\$9,879	\$1,114,021	\$0	\$0	\$1,123,900	(\$185,632)	\$938,268
Marianna & Scenery Hill	\$0	\$204,319	\$0	\$0	\$204,319	(\$54,713)	\$149,606
North-Eastern PA	\$0	\$297,615	\$0	\$0	\$297,615	(\$66,471)	\$231,144
North Penn	\$0	\$96,278	\$0	\$0	\$96,278	(\$16,588)	\$79,690
North Pittsburgh	\$0	\$8,113,646	\$0	\$0	\$8,113,646	(\$3,188,940)	\$4,924,706
Palmerton	\$0	\$951,696	\$30,656	\$0	\$982,352	(\$44,355)	\$937,997
Pennsylvania Telephone	\$0	\$1,176	\$0	\$52,142	\$53,318	(\$900)	\$52,418
Pymatuning	\$0	\$0	\$23,323	\$36,616	\$59,939	\$0	\$59,939
South Canaan	\$0	\$28,600	\$0	\$0	\$28,600	(\$11,616)	\$16,984
Sugar Valley	\$0	\$421,518	\$0	\$41,705	\$463,223	(\$105,687)	\$357,536
Venus	\$0	\$129,611	\$0	\$0	\$129,611	(\$5,149)	\$124,462
Yukon Waltz	\$0	\$97,672	\$0	\$0	\$97,672	(\$20,149)	\$77,523
PA USF Fund Amt	\$5,301,095	\$19,343,657	\$349,194	\$130,463	\$25,124,409	(\$4,607,059)	\$20,517,350

**Calculate ITC IntraLATA Toll Reduction Required to
reach average toll rate of \$0.11**

Company Names	Quarterly IntraLATA Toll Rev	IntraLATA Toll MOUs	ITC Ave IntraLATA Toll Rev Per MOU	Bell Ave IntraLATA Toll Rev Per MOU	ITC Required IntraLATA Toll Rev Reduction Per MOU	Toll Rate Reduction To Mirror Bell Ave Toll Rates	Qtrly IntraLATA Toll Rev Reduction	Annual IntraLATA Toll Rev Reduction
ALLTEL	\$4,143,022	38,412,700	0.1079	0.1100	0.0000	0.00%	\$0	\$0
Armstrong North	\$7,183	60,509	0.1187	0.1100	-0.0087	7.34%	\$527	\$2,108
Armstrong PA	\$90,411	908,351	0.0995	0.1100	0.0000	0.00%	\$0	\$0
Bentleyville	\$189,340	1,696,206	0.1116	0.1100	-0.0016	1.46%	\$2,757	\$11,029
Buffalo Valley	\$381,374	3,442,517	0.1108	0.1100	-0.0008	0.71%	\$2,697	\$10,789
Citizens Communications	\$176,785	1,476,542	0.1197	0.1100	-0.0097	8.13%	\$14,365	\$57,462
Citizens of Kecksburg	\$182,708	1,706,229	0.1071	0.1100	0.0000	0.00%	\$0	\$0
Commonwealth	\$5,285,270	48,047,916	0.1100	0.1100	0.0000	0.00%	\$0	\$0
Conestoga	\$1,095,576	9,505,312	0.1153	0.1100	-0.0053	4.56%	\$49,992	\$199,967
Denver & Ephrata	\$912,520	8,501,904	0.1073	0.1100	0.0000	0.00%	\$0	\$0
Frontier Breezewood	\$27,792	195,310	0.1423	0.1100	-0.0323	22.70%	\$6,308	\$25,232
Frontier Canton	\$48,984	276,187	0.1774	0.1100	-0.0674	37.98%	\$18,603	\$74,414
Frontier Lakewood	\$48,158	407,779	0.1181	0.1100	-0.0081	6.86%	\$3,302	\$13,209
Frontier Oswayo	\$0	0	0.0000	0.1100	0.0000	0.00%	\$0	\$0
Frontier PA	\$373,862	2,354,452	0.1588	0.1100	-0.0488	30.73%	\$114,872	\$459,489
Hickory	\$64,806	503,580	0.1287	0.1100	-0.0187	14.52%	\$9,412	\$37,649
Ironton	\$72,666	524,791	0.1385	0.1100	-0.0285	20.56%	\$14,939	\$59,757
Lackawaxen	\$55,580	548,054	0.1014	0.1100	0.0000	0.00%	\$0	\$0
Laurel Highland	\$194,480	1,599,695	0.1216	0.1100	-0.0116	9.52%	\$18,514	\$74,054
Mahanoy & Mahantango	\$361,689	3,432,846	0.1054	0.1100	0.0000	0.00%	\$0	\$0
Marianna & Scenery Hill	\$112,728	1,127,297	0.1000	0.1100	0.0000	0.00%	\$0	\$0
North-Eastern PA	\$360,559	3,493,653	0.1032	0.1100	0.0000	0.00%	\$0	\$0
North Penn	\$42,136	412,111	0.1022	0.1100	0.0000	0.00%	\$0	\$0
North Pittsburgh	\$3,813,745	41,448,740	0.0920	0.1100	0.0000	0.00%	\$0	\$0
Palmerton	\$232,883	2,047,443	0.1137	0.1100	-0.0037	3.29%	\$7,664	\$30,656
Pennsylvania Telephone	\$25,378	237,174	0.1070	0.1100	0.0000	0.00%	\$0	\$0
Pymatuning	\$44,036	347,319	0.1268	0.1100	-0.0168	13.24%	\$5,831	\$23,323
South Canaan	\$92,343	791,361	0.1167	0.1100	-0.0067	5.73%	\$5,293	\$21,173
Sugar Valley	\$153,764	1,512,381	0.1017	0.1100	0.0000	0.00%	\$0	\$0
Venus	\$15,937	145,615	0.1094	0.1100	0.0000	0.00%	\$0	\$0
Yukon Waltz	\$43,077	416,560	0.1034	0.1100	0.0000	0.00%	\$0	\$0
Totals	\$18,648,791	175,580,534						\$1,100,310

**Calculate Impacts Due To ITC IntraLATA Toll Rate Changes
On Local Residential Rates and/or USF Draw**

COMPANY NAMES	Annual IntraLATA Toll Rev Decrease	Res Access Lines	Required Monthly Local Rate Increase	ITC Current Ave 1-Party Res. Rate	BELL Current Ave 1-Party Res. Rate	Maximum Monthly Local Rate Increase	Actual Monthly Local Rate Increase	Monthly Portion Recovered Thru USF	Toll Rate Reduction Recovered Thru Local Rate Incr	Toll Rate Reduction Recovered via USF Draw
ALLTEL	\$0	180,522	\$0.00	12.74	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
Armstrong North	\$2,108	472	\$0.37	7.58	10.83	\$3.25	\$0.37	\$0.00	\$2,108	\$0
Armstrong PA	\$0	1,450	\$0.00	10.81	10.83	\$0.02	\$0.00	\$0.00	\$0	\$0
Bentleyville	\$11,029	2,753	\$0.33	7.01	10.83	\$3.82	\$0.33	\$0.00	\$11,029	\$0
Buffalo Valley	\$10,789	15,260	\$0.06	7.00	10.83	\$3.83	\$0.06	\$0.00	\$10,789	\$0
Citizens Communications	\$57,462	1,242	\$3.86	9.10	10.83	\$1.73	\$1.73	\$2.13	\$25,784	\$31,678
Citizens of Kecksburg	\$0	4,592	\$0.00	10.54	10.83	\$0.29	\$0.00	\$0.00	\$0	\$0
Commonwealth	\$0	205,373	\$0.00	8.58	10.83	\$2.25	\$0.00	\$0.00	\$0	\$0
Conestoga	\$199,967	40,142	\$0.42	7.36	10.83	\$3.47	\$0.42	\$0.00	\$199,967	\$0
Denver & Ephrata	\$0	40,753	\$0.00	9.94	10.83	\$0.89	\$0.00	\$0.00	\$0	\$0
Frontier Breezewood	\$25,232	3,407	\$0.62	11.14	10.83	\$0.00	\$0.00	\$0.62	\$0	\$25,232
Frontier Canton	\$74,414	3,380	\$1.83	12.94	10.83	\$0.00	\$0.00	\$1.83	\$0	\$74,414
Frontier Lakewood	\$13,209	1,272	\$0.87	11.00	10.83	\$0.00	\$0.00	\$0.87	\$0	\$13,209
Frontier Oswayo	\$0	1,898	\$0.00	15.43	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
Frontier PA	\$459,489	16,909	\$2.26	7.58	10.83	\$3.25	\$2.26	\$0.00	\$459,489	\$0
Hickory	\$37,649	1,062	\$2.95	14.80	10.83	\$0.00	\$0.00	\$2.95	\$0	\$37,649
Ironton	\$59,757	3,705	\$1.34	10.83	10.83	\$0.00	\$0.00	\$1.34	\$0	\$59,757
Lackawaxen	\$0	3,260	\$0.00	10.51	10.83	\$0.32	\$0.00	\$0.00	\$0	\$0
Laurel Highland	\$74,054	4,947	\$1.25	10.48	10.83	\$0.35	\$0.35	\$0.90	\$20,777	\$53,277
Mahanoy & Mahantango	\$0	3,488	\$0.00	15.83	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
Marianna & Scenery Hill	\$0	2,419	\$0.00	15.58	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
North-Eastern PA	\$0	10,431	\$0.00	11.46	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
North Penn	\$0	4,580	\$0.00	10.16	10.83	\$0.67	\$0.00	\$0.00	\$0	\$0
North Pittsburgh	\$0	48,255	\$0.00	8.60	10.83	\$2.23	\$0.00	\$0.00	\$0	\$0
Palmerton	\$30,656	9,562	\$0.27	12.60	10.83	\$0.00	\$0.00	\$0.27	\$0	\$30,656
Pennsylvania Telephone	\$0	1,186	\$0.00	19.30	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
Pymatuning	\$23,323	1,723	\$1.13	16.66	10.83	\$0.00	\$0.00	\$1.13	\$0	\$23,323
South Canaan	\$21,173	2,377	\$0.74	9.23	10.83	\$1.60	\$0.74	\$0.00	\$21,173	\$0
Sugar Valley	\$0	979	\$0.00	18.42	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
Venus	\$0	1,107	\$0.00	13.48	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
Yukon Waltz	\$0	840	\$0.00	15.40	10.83	\$0.00	\$0.00	\$0.00	\$0	\$0
Totals	\$1,100,310								\$751,116	\$349,194

**Calculate Impacts Due To \$16 max avg R1
and maintain R1-B1 Price Ratios**

COMPANY NAMES	Avg R1 Amount above \$16	Annual Reduction amount RES (TO USF)	Ratio of B1-R1	Bus Reduction	Annual Reduction amount BUS (TO USF)	Annual Reduction amount RES+BUS (TO USF)
ALLTEL	\$0.00	\$0	1.78	\$0.00	\$0	\$0
Armstrong North	\$0.00	\$0	1.91	\$0.00	\$0	\$0
Armstrong PA	\$0.00	\$0	1.88	\$0.00	\$0	\$0
Bentleyville	\$0.00	\$0	2.31	\$0.00	\$0	\$0
Buffalo Valley	\$0.00	\$0	2.13	\$0.00	\$0	\$0
Citizens Communications	\$0.00	\$0	3.13	\$0.00	\$0	\$0
Citizens of Kecksburg	\$0.00	\$0	1.76	\$0.00	\$0	\$0
Commonwealth	\$0.00	\$0	1.71	\$0.00	\$0	\$0
Conestoga	\$0.00	\$0	2.10	\$0.00	\$0	\$0
Denver & Ephrata	\$0.00	\$0	1.96	\$0.00	\$0	\$0
Frontier Breezewood	\$0.00	\$0	1.35	\$0.00	\$0	\$0
Frontier Canton	\$0.00	\$0	1.85	\$0.00	\$0	\$0
Frontier Lakewood	\$0.00	\$0	1.72	\$0.00	\$0	\$0
Frontier Oswayo	\$0.00	\$0	1.94	\$0.00	\$0	\$0
Frontier PA	\$0.00	\$0	2.02	\$0.00	\$0	\$0
Hickory	\$0.00	\$0	1.40	\$0.00	\$0	\$0
Ironton	\$0.00	\$0	1.42	\$0.00	\$0	\$0
Lackawaxen	\$0.00	\$0	1.55	\$0.00	\$0	\$0
Laurel Highland	\$0.00	\$0	1.45	\$0.00	\$0	\$0
Mahanoy & Mahantango	\$0.00	\$0	1.84	\$0.00	\$0	\$0
Marianna & Scenery Hill	\$0.00	\$0	1.32	\$0.00	\$0	\$0
North-Eastern PA	\$0.00	\$0	1.63	\$0.00	\$0	\$0
North Penn	\$0.00	\$0	1.69	\$0.00	\$0	\$0
North Pittsburgh	\$0.00	\$0	1.94	\$0.00	\$0	\$0
Palmerton	\$0.00	\$0	2.00	\$0.00	\$0	\$0
Pennsylvania Telephone	\$3.30	\$46,966	0.78	\$3.37	\$5,176	\$52,142
Pymatuning	\$0.66	\$13,646	1.71	\$2.84	\$22,970	\$36,616
South Canaan	\$0.00	\$0	1.17	\$0.00	\$0	\$0
Sugar Valley	\$2.42	\$28,430	1.81	\$6.18	\$13,275	\$41,705
Venus	\$0.00	\$0	1.89	\$0.00	\$0	\$0
Yukon Waltz	\$0.00	\$0	1.57	\$0.00	\$0	\$0
Totals		\$89,042			\$41,421	\$130,463

CALCULATE TOTAL INTRASTATE CCL RELATED REVENUE

Exhibit 1, page 5

Company Names	Annual ITORP Intrastate CCL Access Revenue	Annual IXC Intrastate CCL Access Revenue	Annual Total Intrastate CCL Access Revenue	Annual Total Intrastate Sw Access Revenue	Percent CCL Revenue to CCL + TS Sw Acc Rev	Annual IntraLATA Toll MOUs	Intralata CCL Rate	Support included in Toll Rates	Total Loop support implicit in Toll/Access Rates
ALLTEL	\$6,767,444	\$9,928,304	\$16,695,748	\$13,914,676	54.54%	153,650,800	\$0.038835	\$5,966,996	\$22,662,744
Armstrong North	\$9,481	\$26,156	\$35,637	\$14,871	70.56%	242,036	\$0.047111	\$11,403	\$47,040
Armstrong PA	\$195,372	\$147,616	\$342,988	\$164,420	67.60%	3,633,404	\$0.047101	\$171,135	\$514,123
Bentleyville	\$342,786	\$140,596	\$483,382	\$240,670	66.76%	6,784,824	\$0.046680	\$316,712	\$800,094
Buffalo Valley	\$558,871	\$1,427,248	\$1,986,119	\$1,020,717	66.05%	13,770,068	\$0.044100	\$607,259	\$2,593,378
Citizens Communications	\$630	\$39,222	\$39,852	\$116,776	25.44%	5,906,168	\$0.014107	\$83,317	\$123,169
Citizens of Kecksburg	\$289,356	\$919	\$290,275	\$263,832	52.39%	6,624,916	\$0.047100	\$321,454	\$611,729
Commonwealth	\$5,206,483	\$15,972,880	\$21,179,363	\$15,427,137	57.86%	192,191,664	\$0.043300	\$8,321,891	\$29,501,255
Conestoga	\$1,925,639	\$3,069,420	\$4,995,059	\$3,270,557	60.43%	38,021,248	\$0.041100	\$1,562,675	\$6,557,734
Denver & Ephrata	\$1,081,121	\$3,007,276	\$4,088,397	\$2,531,995	61.75%	34,007,616	\$0.043350	\$1,474,236	\$5,562,632
Frontier Breezewood	\$37,708	\$320,768	\$358,476	\$200,132	64.17%	781,240	\$0.044915	\$35,090	\$393,566
Frontier Canton	\$82,852	\$183,452	\$266,304	\$249,320	51.65%	1,104,748	\$0.047102	\$52,035	\$318,339
Frontier Lakewood	\$71,610	\$78,108	\$149,718	\$86,130	63.48%	1,631,116	\$0.043600	\$71,116	\$220,835
Frontier Oswayo	\$0	\$191,064	\$191,064	\$163,396	53.90%	0	\$0.000000	\$0	\$191,064
Frontier PA	\$340,579	\$1,496,796	\$1,837,375	\$1,322,449	58.15%	9,417,808	\$0.029261	\$275,573	\$2,112,849
Hickory	\$95,776	\$55,812	\$151,588	\$75,176	66.85%	2,014,320	\$0.040005	\$80,582	\$232,170
Ironton	\$166,597	\$291,872	\$458,468	\$275,798	62.44%	2,099,164	\$0.046782	\$98,204	\$556,672
Lackawaxen	\$88,151	\$208,573	\$296,724	\$148,269	66.68%	2,192,216	\$0.047100	\$103,253	\$399,977
Laurel Highland	\$364,422	\$225,552	\$589,974	\$269,136	68.67%	6,398,780	\$0.047100	\$301,383	\$891,357
Mahanoy & Mahantango	\$594,038	\$210,439	\$804,477	\$568,667	58.59%	13,731,384	\$0.047100	\$646,748	\$1,451,225
Marianna & Scenery Hill	\$232,042	\$52,324	\$284,366	\$180,078	61.23%	4,508,188	\$0.047100	\$212,383	\$496,749
North-Eastern PA	\$479,686	\$350,984	\$830,670	\$677,614	55.07%	13,974,612	\$0.047099	\$658,187	\$1,488,857
North Penn	\$17,950	\$456,340	\$474,290	\$290,178	62.04%	1,648,444	\$0.047100	\$77,642	\$551,932
North Pittsburgh	\$3,308,318	\$6,454,964	\$9,763,283	\$6,761,543	59.08%	165,794,960	\$0.042032	\$6,968,696	\$16,731,979
Palmerton	\$388,475	\$1,284,301	\$1,672,776	\$786,683	68.01%	8,189,772	\$0.047098	\$385,725	\$2,058,501
Pennsylvania Telephone	\$41,555	\$50,040	\$91,595	\$45,549	66.79%	948,696	\$0.047104	\$44,688	\$136,282
Pymatuning	\$61,751	\$108,761	\$170,512	\$84,072	66.98%	1,389,276	\$0.045507	\$63,222	\$233,734
South Canaan	\$142,125	\$148,800	\$290,925	\$185,947	61.01%	3,165,444	\$0.046430	\$146,872	\$437,897
Sugar Valley	\$238,561	\$42,712	\$281,273	\$152,866	64.79%	6,049,524	\$0.047100	\$284,933	\$566,205
Venus	\$17,885	\$207,914	\$225,799	\$110,544	67.13%	582,460	\$0.046800	\$27,259	\$253,058
Yukon Waltz	\$118,159	\$45,102	\$163,260	\$72,015	69.39%	1,666,240	\$0.047100	\$78,480	\$241,740
Industry Totals	\$23,265,425	\$46,224,316	\$69,489,741			702,322,136	\$0.041931	\$29,449,246	\$98,938,987

March 12, 1999

**Revise Intrastate Traffic Sensitive (TS) Access Rates to equal
7/98 Interstate TS Rates**

Exhibit 1, page 6

Company Names	Current composite Intrastate TS rate (excl CCL)	Current composite Interstate TS rate (excl CCL)	(Increase)/ Decrease	Qtrly Intrastate TS MOU	Qtrly Impact to implement Interstate TS SW rates	Annual Impact to implement Interstate TS SW rates	Annual Impact to increase Interstate TS SW rates	Annual Impact to decrease Interstate TS SW rates
ALLTEL	0.024887	0.015860	0.009026	139,780,929	(\$1,261,687)	(\$5,046,750)	\$0	(\$5,046,750)
Armstrong North	0.021832	0.039502	(0.017670)	170,283	\$3,009	\$12,036	\$12,036	\$0
Armstrong PA	0.021201	0.037676	(0.016476)	1,938,836	\$31,943	\$127,773	\$127,773	\$0
Bentleyville	0.022139	0.033020	(0.010882)	2,717,765	\$29,574	\$118,297	\$118,297	\$0
Buffalo Valley	0.022664	0.028557	(0.005893)	11,259,215	\$66,355	\$265,419	\$265,419	\$0
Citizens Communications	0.041595	0.018560	0.023035	701,863	(\$16,168)	(\$64,671)	\$0	(\$64,671)
Citizens of Kecksburg	0.024689	0.037514	(0.012825)	2,671,499	\$34,262	\$137,048	\$137,048	\$0
Commonwealth	0.028808	0.041111	(0.012304)	133,880,024	\$1,647,209	\$6,588,836	\$6,588,836	\$0
Conestoga	0.025910	0.032232	(0.006322)	31,556,786	\$199,495	\$797,979	\$797,979	\$0
Denver & Ephrata	0.025782	0.029298	(0.003516)	24,552,415	\$86,332	\$345,326	\$345,326	\$0
Frontier Breezewood	0.022841	0.021174	0.001666	2,190,525	(\$3,650)	(\$14,599)	\$0	(\$14,599)
Frontier Canton	0.036280	0.023931	0.012350	1,718,019	(\$21,217)	(\$84,867)	\$0	(\$84,867)
Frontier Lakewood	0.020577	0.019799	0.000779	1,046,414	(\$815)	(\$3,260)	\$0	(\$3,260)
Frontier Oswayo	0.038147	0.020154	0.017993	1,070,822	(\$19,267)	(\$77,069)	\$0	(\$77,069)
Frontier PA	0.025274	0.027346	(0.002071)	13,080,949	\$27,095	\$108,381	\$108,381	\$0
Hickory	0.019838	0.036042	(0.016203)	947,361	\$15,350	\$61,402	\$61,402	\$0
Ironton	0.026990	0.076550	(0.049560)	2,554,616	\$126,607	\$506,428	\$506,428	\$0
Lackawaxen	0.023535	0.023739	(0.000204)	1,574,973	\$322	\$1,287	\$1,287	\$0
Laurel Highland	0.021486	0.036634	(0.015148)	3,131,499	\$47,437	\$189,747	\$189,747	\$0
Mahanoy & Mahantango	0.027068	0.026598	0.000470	5,252,181	(\$2,470)	(\$9,879)	\$0	(\$9,879)
Marianna & Scenery Hill	0.029301	0.039297	(0.009996)	1,536,424	\$15,357	\$61,430	\$61,430	\$0
North-Eastern PA	0.029222	0.037248	(0.008026)	5,797,084	\$46,525	\$186,098	\$186,098	\$0
North Penn	0.027471	0.032084	(0.004613)	2,640,797	\$12,182	\$48,730	\$48,730	\$0
North Pittsburg	0.028504	0.040150	(0.011645)	59,302,966	\$690,610	\$2,762,441	\$2,762,441	\$0
Palmerton	0.029665	0.034664	(0.004999)	6,629,789	\$33,143	\$132,572	\$132,572	\$0
Pennsylvania Telephone	0.023424	0.036142	(0.012718)	486,128	\$6,183	\$24,731	\$24,731	\$0
Pymatuning	0.018942	0.036479	(0.017537)	1,109,610	\$19,460	\$77,839	\$77,839	\$0
South Canaan	0.029676	0.056053	(0.026377)	1,566,467	\$41,319	\$165,277	\$165,277	\$0
Sugar Valley	0.021683	0.028659	(0.006976)	1,762,516	\$12,295	\$49,179	\$49,179	\$0
Venus	0.034454	0.039235	(0.004781)	802,115	\$3,835	\$15,339	\$15,339	\$0
Yukon Waltz	0.022056	0.035239	(0.013183)	816,269	\$10,761	\$43,042	\$43,042	\$0
Industry Totals				484,247,139	1,881,385	\$7,525,541	\$12,826,635	(\$5,301,095)

March 12, 1999

**Calculate Intrastate CCL Revenue Reduction due to
Implementation of IntraLATA and InterLATA Flat Rated Caps
To Be Recovered via USF Draw**

Company Names	Revised Intrastate CCL Support	Increase in TS rate change to interstate	Revised Intrastate CCL Support	Access Lines	Ave Monthly Intrastate CCL Support per A. L.	Decrease to \$7.00 CAP Intrastate CCL Support per A. L.
ALLTEL	\$22,662,744	\$0	\$22,662,744	226,202	\$8.35	\$1.35
Armstrong North	\$47,040	(\$12,036)	\$35,004	524	\$5.57	\$0.00
Armstrong PA	\$514,123	(\$127,773)	\$386,350	1,654	\$19.47	\$12.47
Bentleyville	\$800,094	(\$118,297)	\$681,798	3,433	\$16.55	\$9.55
Buffalo Valley	\$2,593,378	(\$265,419)	\$2,327,960	20,684	\$9.38	\$2.38
Citizens Communications	\$123,169	\$0	\$123,169	1,328	\$7.73	\$0.73
Citizens of Kecksburg	\$611,729	(\$137,048)	\$474,681	5,392	\$7.34	\$0.34
Commonwealth	\$29,501,255	(\$6,588,836)	\$22,912,418	267,044	\$7.15	\$0.15
Conestoga	\$6,557,734	(\$797,979)	\$5,759,755	52,688	\$9.11	\$2.11
Denver & Ephrata	\$5,562,632	(\$345,326)	\$5,217,306	55,131	\$7.89	\$0.89
Frontier Breezewood	\$393,566	\$0	\$393,566	3,879	\$8.46	\$1.46
Frontier Canton	\$318,339	\$0	\$318,339	3,858	\$6.88	\$0.00
Frontier Lakewood	\$220,835	\$0	\$220,835	1,505	\$12.23	\$5.23
Frontier Oswayo	\$191,064	\$0	\$191,064	2,208	\$7.21	\$0.21
Frontier PA	\$2,112,949	(\$108,381)	\$2,004,567	28,296	\$5.90	\$0.00
Hickory	\$232,170	(\$61,402)	\$170,768	1,319	\$10.79	\$3.79
Ironton	\$556,672	(\$506,428)	\$50,244	4,712	\$0.89	\$0.00
Lackawaxen	\$399,977	(\$1,287)	\$398,690	3,549	\$9.36	\$2.36
Laurel Highland	\$891,357	(\$189,747)	\$701,610	5,592	\$10.46	\$3.46
Mahanoy & Mahantango	\$1,451,225	\$0	\$1,451,225	4,014	\$30.13	\$23.13
Marianna & Scenery Hill	\$496,749	(\$61,430)	\$435,319	2,750	\$13.19	\$6.19
North-Eastern PA	\$1,488,857	(\$186,098)	\$1,302,759	11,966	\$9.07	\$2.07
North Penn	\$551,932	(\$48,730)	\$503,202	4,844	\$8.66	\$1.66
North Pittsburgh	\$16,731,979	(\$2,762,441)	\$13,969,538	69,713	\$16.70	\$9.70
Palmerton	\$2,058,501	(\$132,572)	\$1,925,928	11,598	\$13.84	\$6.84
Pennsylvania Telephone	\$136,282	(\$24,731)	\$111,552	1,314	\$7.07	\$0.07
Pymatuning	\$233,734	(\$77,839)	\$155,895	2,413	\$5.38	\$0.00
South Canaan	\$437,897	(\$165,277)	\$272,620	2,905	\$7.82	\$0.82
Sugar Valley	\$566,205	(\$49,179)	\$517,026	1,137	\$37.89	\$30.89
Venus	\$253,058	(\$15,339)	\$237,719	1,287	\$15.39	\$8.39
Yukon Waltz	\$241,740	(\$43,042)	\$198,698	1,203	\$13.77	\$6.77
TOTALS	\$98,938,987	(\$12,826,635)	\$86,112,352	804,144	\$8.92	

**Calculate Intrastate CCL Revenue Reduction due to
Implementation of IntraLATA and InterLATA Flat Rated Caps
To Be Recovered via USF Draw (Continued)**

<i>Company Names</i>	Annual Intrastate CCL Support Decrease	CCL Support Recovered via USF Draw	Current Support in Toll rates less USF	Total Adj Support	Toll percent	Toll portion per mou %	Toll savings
ALLTEL	\$3,661,776	\$3,661,776	\$5,177,637	\$19,000,968	21.56%	\$4,095,985	\$1,081,652
Armstrong North	\$0	\$0	\$11,403	\$35,004	26.22%	\$9,177	\$2,225
Armstrong PA	\$247,414	\$247,414	\$92,202	\$138,936	31.90%	\$44,325	\$47,876
Bentleyville	\$393,398	\$393,398	\$165,537	\$288,400	38.43%	\$110,827	\$54,710
Buffalo Valley	\$590,504	\$590,504	\$468,988	\$1,737,456	23.42%	\$406,838	\$62,150
Citizens Communications	\$11,617	\$11,617	\$43,765	\$111,552	67.78%	\$75,611	\$0
Citizens of Kecksburg	\$21,725	\$21,725	\$312,986	\$452,956	38.98%	\$176,541	\$136,446
Commonwealth	\$480,694	\$480,694	\$8,194,938	\$22,431,724	26.41%	\$5,924,310	\$2,270,627
Conestoga	\$1,333,963	\$1,333,963	\$1,253,881	\$4,425,792	23.15%	\$1,024,510	\$229,371
Denver & Ephrata	\$586,274	\$586,274	\$1,323,440	\$4,631,032	25.72%	\$1,191,148	\$132,292
Frontier Breezewood	\$67,730	\$67,730	\$4,314	\$325,836	8.19%	\$26,674	\$0
Frontier Canton	\$0	\$0	\$0	\$318,339	13.85%	\$44,088	\$0
Frontier Lakewood	\$94,415	\$94,415	\$31,432	\$126,420	28.04%	\$35,450	\$0
Frontier Oswayo	\$5,565	\$5,565	\$0	\$185,499	0.00%	\$0	\$0
Frontier PA	\$0	\$0	\$275,573	\$2,004,567	15.25%	\$305,768	\$0
Hickory	\$59,972	\$59,972	\$22,119	\$110,796	34.71%	\$38,454	\$0
Ironton	\$0	\$0	\$38,446	\$50,244	17.04%	\$8,563	\$29,884
Lackawaxen	\$100,574	\$100,574	\$77,290	\$298,116	25.81%	\$76,958	\$332
Laurel Highland	\$231,882	\$231,882	\$169,703	\$469,728	33.81%	\$158,823	\$10,880
Mahanoy & Mahantango	\$1,114,021	\$1,114,021	\$206,420	\$337,204	39.53%	\$133,283	\$73,137
Martanna & Scenery Hill	\$204,319	\$204,319	\$125,914	\$231,000	42.32%	\$97,760	\$28,154
North-Eastern PA	\$297,615	\$297,615	\$546,273	\$1,005,144	37.60%	\$377,970	\$168,302
North Penn	\$96,278	\$96,278	\$64,645	\$406,924	13.50%	\$54,931	\$9,715
North Pittsburgh	\$8,113,646	\$8,113,646	\$3,630,783	\$5,855,892	41.14%	\$2,409,084	\$1,221,699
Palmerton	\$951,696	\$951,696	\$130,511	\$974,232	23.60%	\$229,876	\$0
Pennsylvania Telephone	\$1,176	\$1,176	\$44,302	\$110,376	32.79%	\$36,193	\$8,109
Pymatuning	\$0	\$0	\$39,899	\$155,895	23.84%	\$37,164	\$2,735
South Canaan	\$28,600	\$28,600	\$137,372	\$244,020	33.56%	\$81,901	\$55,472
Sugar Valley	\$421,518	\$421,518	\$90,271	\$95,508	46.18%	\$44,107	\$46,164
Venus	\$129,611	\$129,611	\$7,345	\$108,108	15.36%	\$16,610	\$0
Yukon Waltz	\$97,672	\$97,672	\$45,477	\$101,025	33.79%	\$34,135	\$11,342
TOTALS	\$19,343,657	\$19,343,657	\$22,732,865	\$66,768,694	27.44%	\$17,307,065	\$5,683,274

Summary - Estimated Size Of PA USF Fund - Year 2

COMPANY NAMES	Year 1 USF Amount	Initial Carrier Charge	BOY1 Access Lines	Est. Annual Access Line Growth	EOY1 Access Lines	USF Amount Year 2
ALLTEL	\$7,970,369	\$6.73	226,202	3.21%	233,463	\$8,226,218
Armstrong North	\$0	\$5.57	524	3.21%	541	\$0
Armstrong PA	\$187,004	\$3.96	1,654	3.75%	1,716	\$194,017
Bentleyville	\$336,813	\$5.63	3,433	2.80%	3,529	\$346,243
Buffalo Valley	\$571,289	\$6.92	20,684	5.15%	21,749	\$600,710
Citizens Communications	\$107,965	\$7.00	1,328	4.21%	1,384	\$112,511
Citizens of Kecksburg	\$2,399	\$6.70	5,392	3.00%	5,554	\$2,471
Commonwealth	\$480,694	\$7.00	267,044	8.02%	288,461	\$519,246
Conestoga	\$1,332,275	\$7.00	52,688	5.82%	55,754	\$1,409,813
Denver & Ephrata	\$586,274	\$7.00	55,131	4.61%	57,673	\$613,301
Frontier Breezewood	\$107,561	\$7.00	3,879	-3.05%	3,761	\$104,280
Frontier Canton	\$159,281	\$6.88	3,858	0.47%	3,876	\$160,029
Frontier Lakewood	\$108,314	\$6.86	1,505	0.91%	1,519	\$109,300
Frontier Oswayo	\$79,857	\$7.00	2,208	0.46%	2,218	\$80,224
Frontier PA	\$0	\$5.90	28,296	4.40%	29,541	\$0
Hickory	\$97,621	\$7.00	1,319	2.93%	1,358	\$100,481
Ironton	\$56,533	\$0.83	4,712	12.30%	5,292	\$63,487
Lackawaxen	\$97,667	\$6.93	3,549	4.42%	3,706	\$101,984
Laurel Highland	\$285,159	\$7.00	5,592	-0.09%	5,587	\$284,903
Mahanoy & Mahantango	\$938,268	\$3.15	4,014	1.85%	4,089	\$955,626
Marianna & Scenery Hill	\$149,606	\$5.34	2,750	3.58%	2,848	\$154,962
North-Eastern PA	\$231,144	\$6.54	11,966	4.99%	12,563	\$242,679
North Penn	\$79,690	\$6.71	4,844	2.43%	4,962	\$81,627
North Pittsburgh	\$4,924,706	\$3.19	69,713	7.54%	74,969	\$5,296,029
Palmerton	\$937,997	\$6.68	11,598	1.75%	11,801	\$954,412
Pennsylvania Telephone	\$52,418	\$6.94	1,314	3.41%	1,359	\$54,206
Pymatuning	\$59,939	\$5.38	2,413	6.02%	2,558	\$63,548
South Canaan	\$16,984	\$6.67	2,905	6.18%	3,085	\$18,034
Sugar Valley	\$357,536	\$0.00	1,137	3.01%	1,171	\$368,298
Venus	\$124,462	\$6.67	1,287	2.64%	1,321	\$127,748
Yukon Waltz	\$77,523	\$5.60	1,203	10.18%	1,325	\$85,415
PA USF Fund Amt	\$20,517,350		\$804,144			\$21,431,800

Summary - Estimated Size Of PA USF Fund - Year 3

COMPANY NAMES	Year 2 USF Amount	Year 2 Carrier Charge	BOY2 Access Lines	Est. Annual Access Line Growth	EOY2 Access Lines	USF Amount Year 3
ALLTEL	\$8,226,218	\$6.73	233,463	3.21%	240,957	\$8,490,279
Armstrong North	\$0	\$5.57	541	3.21%	558	\$0
Armstrong PA	\$194,017	\$3.96	1,716	3.75%	1,780	\$201,292
Bentleyville	\$346,243	\$5.63	3,529	2.80%	3,628	\$355,938
Buffalo Valley	\$600,710	\$6.92	21,749	5.15%	22,869	\$631,647
Citizens Communications	\$112,511	\$7.00	1,384	4.21%	1,442	\$117,247
Citizens of Kecksburg	\$2,471	\$6.70	5,554	3.00%	5,721	\$2,545
Commonwealth	\$519,246	\$7.00	288,461	8.02%	311,596	\$560,890
Conestoga	\$1,409,813	\$7.00	55,754	5.82%	58,999	\$1,491,864
Denver & Ephrata	\$613,301	\$7.00	57,673	4.61%	60,332	\$641,574
Frontier Breezewood	\$104,280	\$7.00	3,761	-3.05%	3,646	\$101,100
Frontier Canton	\$160,029	\$6.88	3,876	0.47%	3,894	\$160,781
Frontier Lakewood	\$109,300	\$6.86	1,519	0.91%	1,533	\$110,295
Frontier Oswayo	\$80,224	\$7.00	2,218	0.46%	2,228	\$80,593
Frontier PA	\$0	\$5.90	29,541	4.40%	30,841	\$0
Hickory	\$100,481	\$7.00	1,358	2.93%	1,398	\$103,425
Ironton	\$63,487	\$0.83	5,292	12.30%	5,943	\$71,296
Lackawaxen	\$101,984	\$6.93	3,706	4.42%	3,870	\$106,492
Laurel Highland	\$284,903	\$7.00	5,587	-0.09%	5,582	\$284,646
Mahanoy & Mahantango	\$955,626	\$3.15	4,089	1.85%	4,165	\$973,305
Marianna & Scenery Hill	\$154,962	\$5.34	2,848	3.58%	2,950	\$160,510
North-Eastern PA	\$242,679	\$6.54	12,563	4.99%	13,190	\$254,788
North Penn	\$81,627	\$6.71	4,962	2.43%	5,083	\$83,611
North Pittsburgh	\$5,296,029	\$3.19	74,969	7.54%	80,622	\$5,695,349
Palmerton	\$954,412	\$6.68	11,801	1.75%	12,008	\$971,114
Pennsylvania Telephone	\$54,206	\$6.94	1,359	3.41%	1,405	\$56,054
Pymatuning	\$63,548	\$5.38	2,558	6.02%	2,712	\$67,373
South Canaan	\$18,034	\$6.67	3,085	6.18%	3,276	\$19,148
Sugar Valley	\$368,298	\$0.00	1,171	3.01%	1,206	\$379,384
Venus	\$127,748	\$6.67	1,321	2.64%	1,356	\$131,121
Yukon Waltz	\$85,415	\$5.60	1,325	10.18%	1,460	\$94,111
PA USF Fund Amt	\$21,431,800		848,733			\$22,397,772

Summary - Estimated Size Of PA USF Fund - Year 4

COMPANY NAMES	Year 3 USF Amount	Year 3 Carrier Charge	BOY3 Access Lines	Est. Annual Access Line Growth	EOY3 Access Lines	USF Amount Year 4
ALLTEL	\$8,490,279	\$6.73	240,957	3.21%	248,692	\$8,762,817
Armstrong North	\$0	\$5.57	558	3.21%	576	\$0
Armstrong PA	\$201,292	\$3.96	1,780	3.75%	1,847	\$208,841
Bentleyville	\$355,938	\$5.63	3,628	2.80%	3,730	\$365,904
Buffalo Valley	\$631,647	\$6.92	22,869	5.15%	24,047	\$664,177
Citizens Communications	\$117,247	\$7.00	1,442	4.21%	1,503	\$122,183
Citizens of Kecksburg	\$2,545	\$6.70	5,721	3.00%	5,893	\$2,621
Commonwealth	\$560,890	\$7.00	311,596	8.02%	336,586	\$605,873
Conestoga	\$1,491,864	\$7.00	58,999	5.82%	62,433	\$1,578,691
Denver & Ephrata	\$641,574	\$7.00	60,332	4.61%	63,113	\$671,151
Frontier Breezewood	\$101,100	\$7.00	3,646	-3.05%	3,535	\$98,016
Frontier Canton	\$160,781	\$6.88	3,894	0.47%	3,912	\$161,537
Frontier Lakewood	\$110,295	\$6.86	1,533	0.91%	1,547	\$111,298
Frontier Oswayo	\$80,593	\$7.00	2,228	0.46%	2,238	\$80,964
Frontier PA	\$0	\$5.90	30,841	4.40%	32,198	\$0
Hickory	\$103,425	\$7.00	1,398	2.93%	1,439	\$106,455
Ironton	\$71,296	\$0.83	5,943	12.30%	6,674	\$80,065
Lackawaxen	\$106,492	\$6.93	3,870	4.42%	4,041	\$111,199
Laurel Highland	\$284,646	\$7.00	5,582	-0.09%	5,577	\$284,390
Mahanoy & Mahantango	\$973,305	\$3.15	4,165	1.85%	4,242	\$991,311
Marianna & Scenery Hill	\$160,510	\$5.34	2,950	3.58%	3,056	\$166,256
North-Eastern PA	\$254,788	\$6.54	13,190	4.99%	13,848	\$267,502
North Penn	\$83,611	\$6.71	5,083	2.43%	5,207	\$85,642
North Pittsburgh	\$5,695,349	\$3.19	80,622	7.54%	86,701	\$6,124,778
Palmerton	\$971,114	\$6.68	12,008	1.75%	12,218	\$988,109
Pennsylvania Telephone	\$56,054	\$6.94	1,405	3.41%	1,453	\$57,965
Pymatuning	\$67,373	\$5.38	2,712	6.02%	2,875	\$71,429
South Canaan	\$19,148	\$6.67	3,276	6.18%	3,478	\$20,332
Sugar Valley	\$379,384	\$0.00	1,206	3.01%	1,242	\$390,803
Venus	\$131,121	\$6.67	1,356	2.64%	1,392	\$134,582
Yukon Waltz	\$94,111	\$5.60	1,460	10.18%	1,609	\$103,691
PA USF Fund Amt	\$22,397,772		896,250			\$23,418,584

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

EXHIBIT 2

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**PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, Pennsylvania 17105-3265**

Public Meeting held July 10, 2003

Commissioners Present:

Terrance J. Fitzpatrick, Chairman
Robert K. Bloom, Vice Chairman
Aaron Wilson, Jr.
Glen R. Thomas
Kim Pizzigrilli

Access Charge Investigation per Global	:	Docket Nos. M-00021596
Order of September 30, 1999	:	P-00991648
	:	P-00991649
Verizon Pennsylvania Inc.'s 2003	:	
Price Change Opportunity	:	Docket No. M-00031694
	:	
AT&T Communications of	:	
Pennsylvania, Inc.,	:	
v.	:	Docket Nos.
	:	M-00031694C0001
Verizon Pennsylvania Inc.	:	P-00930715
Re: Verizon Pennsylvania Inc.'s	:	
2003 PCO	:	

ORDER

BY THE COMMISSION:

Presently before this Commission for consideration is the Joint Procedural Stipulation filed on June 5, 2003, by the Rural Telephone Company Coalition (RTCC), The United Telephone Company of Pennsylvania (Sprint/United), Office of Trial Staff (OTS), Office of Consumer Advocate (OCA), Office of Small Business Advocate (OSBA), AT&T Communications of Pennsylvania, Inc. LLC (AT&T), Verizon Pennsylvania Inc., Verizon North Inc. (Verizon), and MCI WorldCom Network Services, Inc. (MCI). The Joint Procedural Stipulation concerns the RTCC/Sprint United Joint Proposal for Access Charge Reductions (Joint Proposal) for the rural telephone companies that had been filed on December 16, 2002, pursuant to the generic access charge investigation at M-00021596.

**ATTACHMENT A
RTCC/SPRINT/OCA/OTS/OSBA
JOINT ACCESS PROPOSAL
IN RESPONSE TO THE COMMISSION'S
ACCESS CHARGE INVESTIGATION - PHASE II**

Defined Terms

As employed herein, the following terms shall have these *specified meanings*:

"ILEC" means an RTCC member or The United Telephone Company of Pennsylvania d/b/a Sprint ("Sprint").

"RTCC" means Rural Telephone Company Coalition. The RTCC members are ALLTEL Pennsylvania, Inc. ("ALLTEL"), Armstrong Telephone Company . PA, Armstrong Telephone Company. North, Bentleyville Communications Corporation, d/b/a The Bentleyville Telephone Company, Buffalo Valley Telephone Company ("Buffalo Valley"), Citizens Telephone Company of Kecksburg, Citizens Telecommunications Company of New York,¹¹ Commonwealth Telephone Company ("Commonwealth"), Conestoga Telephone and Telegraph Company ("Conestoga"), Denver and Ephrata Telephone and Telegraph Company ("D&E"), Deposit Telephone Company, Frontier Communications of Breezewood, Inc., Frontier Communications of Canton, Inc., Frontier Communications of Lakewood, Inc., Frontier Communications of Oswayo River, Inc., Frontier Communications of Pennsylvania, Inc. ("Frontier PA"), The Hancock Telephone Company, Hickory Telephone Company, Ironton Telephone Company, Lackawaxen Telecommunications Services, Inc., Laurel Highland Telephone Company, Mahanoy & Mahantango Telephone Co., Marianna & Scenery Hill Telephone Company, The North-Eastern PA Telephone Company, North Penn Telephone Company, North Pittsburgh Telephone Company ("NPTC"), Palmerton Telephone Company, Pennsylvania Telephone Company, Pymatuning Independent Telephone Company, South Canaan Telephone Company, Sugar Valley Telephone Company, Venus Telephone Corporation, and Yukon-Waltz Telephone Company.

"Larger ILEC," for purposes of this Proposal only,¹² means ALLTEL, Buffalo Valley, Commonwealth, Conestoga, D&E, Frontier PA, NPTC, and Sprint.

"Smaller ILEC," for purposes of this Proposal only, means any RTCC member that is not a Larger ILEC.

¹¹ Because Citizens Telecommunications Company of New York has and continues to operate under New York access tariffs, it is not to be deemed a party to this proposal. Likewise, West Side Telephone Company was not included in the Global proceeding and is excluded here.

¹² The designation of larger and smaller ILEC was based upon the factor of 20,000 access lines and was for purposes of this Proposal only, for the purpose of redirecting monies out of the existing USF that were previously allocated to Sprint.

Elements of Proposal

- 1) **If an ILEC's intrastate traffic sensitive (TS) rates exceed its interstate TS rates, the ILEC may, at its sole discretion, lower its intrastate TS rates to match or move closer to its interstate TS rates, and simultaneously increase its Carrier Charge (CC) by a corresponding revenue neutral amount using the 12 months ended August 31, 2002, or the most current 12 month period, thereby creating a revised CC. An ILEC may, at its sole discretion, lower its intrastate TS rates to match or move closer to its interstate TS rates, and simultaneously increase its Carrier Charge (CC) by a corresponding revenue-neutral amount, again in 2004, using a recent 12 month period, thereby creating a further revised CC. All references to CC herein shall be to the then current revised CC if the ILEC has chosen to implement this element of the proposal.**
- 2) **Pursuant to an Order entered adopting this access proposal without modification, and after notice through bill insert, bill message or separately mailed notice to all customers at least 30 days prior to the date of any rate change, each ILEC will increase local rates, based upon one-day tariff compliance filing, to be effective on a date between January 1, 2003 and December 31, 2003 (as to be determined at the sole discretion of the individual ILEC) as follows:**
 - (a) **Each ILEC with a weighted average R-1 rate below \$10.83 as of December 31, 2002, will increase its R-1 rates in a manner to achieve a weighted average R-1 rate of \$11. If the increase results in R-1 rates greater than 150% of the current rate, then the increase shall be implemented in two steps, the second of which shall become effective no later than December 31, 2003. This increase shall be subject to the Company's Chapter 30 Plan rate rebalancing limitation with respect to the limitation on calendar year per line increases, i.e. not more than \$3.50 per line per month in rate increases in any one year, but shall not be subject to any other Chapter 30 process or requirements. To the extent that any ILEC shall not be able to complete the required rate increase within any year, such rate increase may be deferred to the following year subject to the Company's Chapter 30 Plan rate rebalancing limitations. Any rate rebalancing in excess of that specifically referenced in Paragraph 2 shall be subject to the Chapter 30 Plan rate rebalancing process and requirements.**
 - (b) **Each ILEC with a weighted average R-1 rate between \$10.83 - \$12 as of December 31, 2002, will increase its R-1 rates in a manner to achieve a weighted average R-1 rate of \$13.50.**
 - (c) **Each ILEC with a weighted average R-1 rate between \$12.01 - \$14 as of December 31, 2002, will increase its R-1 rates in a manner to achieve a weighted average R-1 rate of \$15.**
 - (d) **Each ILEC with a weighted average R-1 rate between \$14.01-\$16 as of December 31, 2002, will increase its R-1 rates in a manner to achieve a weighted average R-1 rate of \$16.**

- (e) Each ILEC may, at its sole option, increase its weighted average Business line rate by up to the same amount that its weighted average R-1 rate is increased, but in no event may the B-1 rate be less than the R-1 rate.
- 3) Pursuant to an Order entered adopting this access proposal without modification, and after notice through bill insert, bill message or separately mailed notice to all customers at least 30 days prior to the date of any rate change, each ILEC may increase local rates, based upon a one-day tariff compliance filing, to be effective on a date between January 1, 2004 and December 31, 2004 (as to be determined at the sole discretion of the individual ILEC) as follows:
 - (a) Each ILEC with a weighted average R-1 rate of \$11 (or less) as of December 31, 2003 (as described and calculated in Step 2 above) may increase its R-1 rates in a manner to achieve a weighted average R-1 rate of \$13.50.
 - (b) Each ILEC with a weighted average R-1 rate of \$13.50 as of December 31, 2003 (as described and calculated in Step 2 above) may increase its R-1 rates in a manner to achieve a weighted average R-1 rate of \$15.
 - (c) Each ILEC with a weighted average R-1 rate of \$15 as of December 31, 2003 (as described and calculated in Step 2 above) may increase its R-1 rates in a manner to achieve a weighted average R-1 rate of \$17.
 - (d) Each ILEC with a weighted average R-1 rate of \$16 as of December 31, 2003 (as described and calculated in Step 2 above) may increase its R-1 rates in a manner to achieve a maximum weighted average R-1 rate of \$18.
 - (e) Each ILEC may, at its sole option, increase its weighted average Business line rate by up to the same amount that its weighted average R-1 rate is increased, but in no event may the B-1 rate be less than the R-1 rate.

Any rate rebalancing in excess of that specifically referenced in Paragraphs 2 and 3 shall be subject to the Chapter 30 Plan rate rebalancing process and requirements.

- 4) The monthly \$16.00 cap on R-1 average rates established in the Global Order and any ILEC-specific weighted average rate cap which may have been established in any individual ILEC's Chapter 30 Plan will be increased for all ILECs to the weighted average \$18.00 cap for a minimum three (3) year period January 1, 2004 through December 31, 2006. As to any ILEC which as of July 1, 2002 has hit the \$16.00 cap and takes a credit from the USF, the ILEC shall continue to receive and apply the credit but would be limited to recovering from its customers future R-1 increases of \$2.00 under the foregoing \$18.00 cap reflecting the USF credit in effect as of July 1, 2002. Any approved future increases in rates above the \$18.00 rate cap for any ILEC shall also be recoverable from the USF under the exact same terms and conditions as approved in the Global Order. For example, if ILEC A's R-1 rates are currently \$17.25, then their customer is billed \$17.25 but receives a credit of \$1.25 from USF, receiving a net bill of \$16.00. ILEC A could, as of December 31, 2004, implement the provisions of Paragraph 3 hereof, increase its rates, if justified, by \$2.00 to \$19.25, charge its customers \$19.25, reflect a credit of \$1.25 to its customers, receive \$1.25 from the USF, and then send a net bill to its customers of \$18.00. If ILEC A justified an R-1 rate of \$20.25, then it would be entitled to \$2.25 from the USF and will send a net bill to its customers of \$18.00.
- 5) Pursuant to an Order entered adopting this access proposal without modification, each ILEC shall have the right, in whole or in part, in lieu of raising local service rates as provided in Paragraphs 2 and 3 hereof to raise rates on other services by an equivalent amount, based on a one-day tariff compliance filing.
- 6) To offset the increase to local rates described above in Paragraphs 2 and 3, each ILEC (except Sprint) will file a compliance tariff(s) to reduce its CC or TS rates, or any combination thereof, by a revenue-neutral amount (depending upon changes undertaken in Paragraph 1, above), effective on dates consistent with the increases in Paragraphs 2 and 3.
- 7) In addition to any rate modifications undertaken pursuant to Paragraphs 2 and 3, each Smaller ILEC that increases its rates consistent with Paragraph 2, above, or is at the \$16.00 capped rates on December 31, 2003, will additionally reduce its CC or TS rates, or any combination thereof, by the equivalent of \$2 per line per month effective January 1, 2004 and shall receive an equal (a revenue-neutral) amount of support from the PA USF (annual total for all Smaller ILECs ranging from an estimated \$1.8 million to \$2.2 million), as provided in Paragraph 8.b. For ease of administration, the amount of additional USF received by the Smaller ILECs under this proposal will be determined as of December 31, 2003, and will be applied effective January 1, 2004 and each year thereafter for the duration of the Pa. USF (as addressed in Paragraph 1 of the Conditions of Proposal.) Beginning in 2005, any growth in access lines shall be accounted for in accordance with the annual USF calculation in 52 Pa. Code §63.165 and the Smaller ILECs'

total receipt from the Pa. USF, including the amount provided for herein, shall be included in the Smaller ILECs' prior year funding.

- 8)
 - (a) To offset the increase to Sprint's local rates described above in Paragraph 2, above, Sprint will file compliance tariff(s) to reduce its CC or TS rates, or any combination thereof, by a revenue-neutral amount (depending upon changes undertaken in Paragraph 1, above) effective on dates consistent with the increases in Paragraph 2.
 - (b) Beginning on or after January 1, 2004, Sprint will reduce its receipt from the current PA USF equal to the \$2 per line per month reduction to the CC or TS, from Smaller ILECs as expressed in Paragraph 7. These dollars (annual total ranging from an estimated \$1.8 million to \$2.2 million) will be directly paid to the Smaller ILECs, as described in Paragraph 7, from the PA USF to offset the Smaller ILECs' reduction in access charges on a revenue neutral basis.
- 9) On/or after January 1 of each year beginning in 2005 each ILEC may request such rate changes or rate rebalancing as are permitted by any Chapter 30 Plans and/or applicable statutory and regulatory provisions.

Conditions of Proposal

- 1) The only change to the existing universal service fund in PA is that Sprint will be shifting a portion (estimated to be \$1.8 m - \$2.2m) of its current fund receipt (\$9 million) to Smaller ILECs as noted in Paragraphs 7 and 8 above. This Proposal is dependent upon all other aspects of the PA universal service program and the USF regulations remaining intact, including the recovery of rates above the rate cap into the future, specifically beyond December 31, 2003. The existing universal service fund, including the recovery of monies under Paragraph 4 of Elements of Proposal above, and regulations promulgated thereunder shall, as provided in the regulations, continue in place until modified by further Commission rulemaking.
- 2) Each ILEC reserves the right, subject to Chapter 30 Plan requirements, to change its access rates to ensure that each access rate element at least recovers its cost and the ILEC's service price index continues to be equal to or less than the ILEC's price stability index, in the event the ILEC's access rates are determined to be below cost based upon the development of a cost study.
- 3) This proposal is made in its entirety and no part hereof is valid or binding unless all components are accepted by all parties. Should any part be specifically modified or otherwise adversely impacted at any later date as to any ILEC or party, the ILEC or party shall have full unilateral rights to withdraw from the plan or revisit the plan in its sole discretion. This potential agreement is proposed by the parties to settle the instant

controversy and is made without any admission against or use that is intended to prejudice any positions which any party might adopt during subsequent litigation, including further litigation in related proceedings. This agreement is conditioned upon the Commission's approval of all terms and conditions contained herein, except for the terms of this paragraph. If the Commission should fail to grant such approval or should modify the terms and conditions herein, this agreement may be withdrawn upon written notice to the Commission and all parties within five business days by any of the parties and, in such event, shall be of no force and effect. In the event that the Commission does not approve the Settlement or any party elects to withdraw as provided above and any proceeding continues, the parties reserve their respective rights to submit testimony or other pleadings and briefs in this or a related proceeding.

- 4) Elements of this Proposal shall constitute rate rebalancings or rate filings as defined and allowed under each ILEC's Chapter 30 Plan only to the extent of determining the maximum amount of an increase allowed per year, but shall not preclude the filing of one additional rate restructuring/rebalancing filing in the calendar year so long as the total rate rebalancing rate increases do not exceed the maximum annual increase allowed and comply with other Chapter 30 Plan limitations and requirements. That is, implementation of proposed Paragraphs 2, 3 and 5 under Elements of Proposal are not considered rate rebalancings under the Chapter 30 Plans except in determining the maximum limitation on per year line rate increases to monthly dial tone rates. All parties retain all other rights under the approved Chapter 30 Plan to implement or oppose all rate rebalancings and other rate filings permitted under its Chapter 30 Plan. All parties reserve all rights in any proceedings relative to Chapter 30.
- 5) Increases to weighted average business rates on a dollar basis will be less than or equal to the increases to weighted average residential rates on a dollar basis.
- 6) This access proposal will be revenue neutral relative to each ILEC implementing a rate change. Absolutely no changes shall be required which are not revenue-neutral. Other access reductions that are not revenue neutral are permissible at the ILEC's sole option, but not required.
- 7) When notice is sent to each company's customers as provided in Paragraphs 2 and 3 under elements of Proposal, it will also be served upon all parties to this Proposal.

EXHIBIT 3

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**UNITED STATES SECURITIES AND EXCHANGE
COMMISSION**

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from to

Commission File No. 000-20709

D&E Communications, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of
incorporation or organization)

23-2837108
(I.R.S. Employer Identification No.)

124 East Main Street
P.O. Box 458
Ephrata, PA
(Address of principal executive offices)

17522-0458
(Zip Code)

Registrant's telephone number, including area code:
(717) 733-4101

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

None.

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

Common Stock, par value \$0.16 per share
(Title of Class)

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes ☒ No ☐

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

Large Accelerated Filer ☐

Accelerated Filer ☒

Non-accelerated Filer ☐

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2005 was approximately \$117,176,710. Such aggregate market value was computed by reference to the closing price of the registrant's Common Stock as reported on the Nasdaq National Market on June 30, 2005. For purposes of making this calculation only, the registrant has defined affiliates to include all directors, executive officers and beneficial owners of more than ten percent of the Common Stock of the registrant.

The number of shares of the registrant's Common Stock outstanding as of March 3, 2006 was 14,348,066.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for its 2006 annual meeting of stockholders are incorporated by reference into Part III of this Form 10-K.

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Our disclosure and analysis in this report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements provide our current expectations or forecasts of future events. You can identify these statements by the fact that they do not relate strictly to historical or current facts. These statements may relate to our financial condition, results of operations, plans, objectives, future performance and business. Often these statements include words such as “believes,” “expects,” “anticipates,” “estimates,” “intends,” “strategy,” “plan,” or similar words or expressions. In particular, statements, express or implied, concerning future operating results or the ability to generate income or cash flows are forward-looking statements. Forward-looking statements involve certain risks and uncertainties. Our actual performance or achievements may differ materially from those contemplated by forward-looking statements.

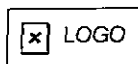
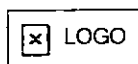
You should understand that various factors, including those discussed in the section titled “Item 1A. Risk Factors” and elsewhere in this document could affect our future results and could cause results to differ materially from those expressed in these forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this document. All subsequent written and oral forward-looking statements attributable to us are expressly qualified in their entirety by the cautionary statements contained or referred to in this report. We do not undertake any obligation to release publicly any revisions to these forward-looking statements to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.

Item 1. *Business***Overview**

We are a provider of integrated communications services to residential and business customers in markets throughout the eastern half of Pennsylvania. We have operated as a rural local exchange carrier (“RLEC”) in parts of Lancaster, Berks, Lebanon, Chester, Montgomery, Lehigh, Union and Northumberland counties in Pennsylvania since the early 1900s and were among the first to deploy a 100% digitally switched network. In 1998, we began operating as a competitive local exchange carrier (“CLEC”) and currently operate in the Lancaster, Reading, State College, Pottstown, Williamsport, Altoona and Harrisburg, Pennsylvania areas, which we refer to as our “edge-out” markets. Today, we offer our customers a comprehensive package of communications services, including local and long distance telephone services, high-speed data, or broadband, services, Internet access services and integrated voice and data network solutions throughout our territory. Additionally, in the State College and Lewisburg areas, we also provide video services. Our reporting segments are RLEC, CLEC, Internet Services and Systems Integration.

As of December 31, 2005, we served 134,698 RLEC access lines, 40,796 CLEC access lines, 19,795 digital subscriber line (“DSL”) subscribers, 7,959 dial-up internet access subscribers, 6,630 video subscribers and 952 web-hosting customers. For the year ended December 31, 2005, we generated revenue of \$176.2 million, operating income of \$22.7 million and a net income of \$13.7 million.

Historically, we have derived a majority of our revenues from the regulated RLEC segments. The RLEC segment accounted for approximately 57% of total 2005 revenues and all of our operating income. Our RLEC revenue is derived primarily from local telephone service, network access charges, enhanced telephone services, directory advertising, private line service and regional toll service. Our CLEC focuses primarily on businesses, and revenue is derived primarily from local telephone service, network access charges, enhanced telephone services, private line service and long distance service revenue. Our Internet Services revenue is derived from broadband and dial-up Internet access services, in addition to web-hosting services and our new Voice over Internet Protocol (“VoIP”) service. Our Systems Integration revenue is derived from sales of services and equipment that support the design, implementation and maintenance of local and wide area networks and telecommunications systems. The following graphs represent fiscal year segment revenues and operating income.

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We own a one-third interest in EuroTel, LLC, which owns 100% of Pennecom BV, a Netherlands company. We presently maintain a minority interest in these ventures. Pennecom continues to pursue legal action that it initiated in July 2002 in the United States District Court for the Southern District of New York (see Item 3 Legal Proceedings).

Our common stock is listed for quotation on the National Market System of the National Association of Securities Dealers Automated Quotation System under the symbol "DECC". Our internet address is www.decommunications.com. Electronic copies of the 2005 Annual Report on Form 10-K are available free of charge by visiting the "Investor Relations" section of www.decommunications.com. Electronic copies of quarterly reports on Form 10-Q and current reports on Form 8-K are also available at this internet address. These reports are posted as soon as reasonably practicable after they are electronically filed with the United States Securities and Exchange Commission (SEC).

Our principal offices are located at 124 E. Main Street, Ephrata, Pennsylvania 17522, and we can be reached by telephone by calling (717) 733-4101 or through our website at www.decommunications.com. The contents of this website are not part of this filing. We are a Pennsylvania corporation.

Recent Developments

Pilicka Telefonja Sp. z o.o.

On December 19, 2005, we sold our direct and indirect interest in Pilicka Telefonja Sp. z o.o. ("Pilicka") which operates a telephone network in a region south of Warsaw, Poland. We recorded pre-tax income of approximately \$6.4 million as a result of the sale.

PenTeleData Limited Partnership I

On February 28, 2005, we sold our interest in PenTeleData Limited Partnership I for \$2.9 million resulting in a gain of \$2.0 million before taxes. The investment in PenTeleData was reported in other long-term assets on the balance sheet at December 31, 2004.

Debt Refinancing

On March 5, 2004, we completed a syndicated senior secured debt financing in the amount of \$260 million jointly arranged by CoBank, ACB and SunTrust Bank. The credit facilities are in the form of a \$25 million Revolving Loan, Term Loan A in the amount of \$50 million, Term Loan B in the amount of \$150 million, and the assumption of \$35 million of term indebtedness of a D&E subsidiary. The debt was assigned a "BB-" rating by Standard & Poor's Rating Services and a "Ba3" rating by Moody's Investor Services. Moody's Investors Services reaffirmed their "Ba3" rating in the third quarter of 2005. Standard and Poor's Rating Services reaffirmed their "BB-" rating in the fourth quarter of 2005.

Further, on November 22, 2004, we entered into an amendment with respect to the Term Loan B portion of this senior financing. The amendment reduced the applicable LIBOR margin of Term Loan B from 2.75% to 2.00% through its stated maturity date of December 31, 2011.

In light of the favorable market conditions and opportunities which appear to be available to the Company due to its performance, we are considering alternatives available to us to take advantage of low market interest rates and to amend existing loan amortization schedules and/or loan covenants. There is no assurance that our evaluation of the alternatives will result in a favorable restructuring of our indebtedness.

The Telecommunications Industry

The telecommunications industry is comprised of companies involved in the transmission of voice, data and video communications over various media and through various technologies from the point of origination to the

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point of termination. In recent years the industry has undergone significant change due to competition, the construction of additional infrastructure and the introduction of new technologies, which has resulted in increased demand for telecommunications services. The Telecommunications Act of 1996 ("TA-96") and its subsequent interpretation and implementation by the Federal Communications Commission ("FCC") has had a far reaching impact on telecommunications companies, regulators and customers.

There are two predominant types of local wireline telephone service providers in the telecommunications industry: Incumbent Local Exchange Carriers ("ILEC") and Competitive Local Exchange Carriers ("CLEC"). Within the ILEC sector, generally there are Rural Local Exchange Carriers ("RLEC"), which operate in rural areas, RLEC aggregators, which operate multiple RLEC properties throughout the United States, and Regional Bell Operating Companies ("RBOC").

The passage of TA-96, with its stated goal of encouraging the rapid deployment of new telecommunications technologies and promoting competition to ensure lower prices and higher quality services for U.S. telecommunications customers, substantially changed the telecommunications industry. TA-96 permitted newly created CLECs to compete with ILECs. As a result, ILEC and CLEC operators increasingly seek to differentiate themselves by bundling their communications service offerings and providing high quality customer service. Both ILEC and CLEC operators face other competitive methods of delivering communications services including wireless telephones, cable service, satellite transmission and voice over the Internet protocol ("VoIP") service.

Despite competition introduced into the telecommunications industry as a result of the passage of TA-96, many large RLECs continue to grow their business by capitalizing on their extensive networks, favorable demographic trends and the increasing demand for communications services, including new service offerings such as broadband and enhanced telephone services. There are also a number of RLECs that operate in rural areas where competition from CLECs generally has been minimal due to regulatory factors, including exemptions from rules applicable to the RBOCs that require competitive access as mandated by TA-96, and the unfavorable economics of constructing and operating competitive systems in rural areas. Additionally, there has been consolidation among RLECs, which has created economies of scale and the ability to cross-sell new services across a larger customer base. Nationally, there are a large number of RLECs similar to ours that operate in sparsely populated rural areas where competition from CLECs generally has been minimal due to these same economic and competitive conditions. Most of these RLECs have fewer than 50,000 access lines.

Business Strategy

Our primary business objective is to be a leading, regional integrated communications service provider ("ICP"). To achieve this objective, we will continue to pursue the following goals:

- We will pursue the goal of capturing as many broadband connections to customers' homes and businesses as possible. While we intend to continue to serve our dial-up Internet access customer base, our focus will be to migrate these customers in the RLEC and CLEC areas to broadband connections. New broadband customers will also be aggressively pursued. Targeting customers with a broadband connection to their home and/or business is vital for the future delivery of Internet Protocol ("IP") services.
- We will continue to build-out our fiber-to-the-node infrastructure to support the future deployment of advanced broadband IP communication services. We expect that the demands of our residential and business customers for increased bandwidth and IP applications will continue to grow.
- We will continue to operate under a disciplined strategy to increase our market share in our edge-out markets, primarily to business customers, by offering competitive communication service packages. We will continue to leverage our modern network infrastructure, established reputation, extensive local knowledge and significant operating experience to attempt to gain new customers and increase our market share in our edge-out markets. Our focus will be on acquiring customers that can be served from our own network facilities and moving existing customers from leased facilities to our own network.

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- We will pursue the goal of delivering excellence for our customers by providing reliable, responsive, state of the art broadband communications services, including voice, high-speed data, VoIP and, in certain of our RLEC and CLEC markets, video. We will assess and tailor the bundling of services to best serve our customers and endeavor to achieve a competitive advantage in our local markets. We have direct experience with video deployments on two technology platforms – hybrid fiber coaxial in the State College CLEC market and ADSL2 over the RLEC copper system in Union County, Pennsylvania. The potential roll-out of video in our other RLECs is under review and evaluation.
- We will endeavor to be a single source provider of voice and data communications services to our business customers. We believe that the convergence and complexity of voice communications and data network technologies has increased the need for businesses to seek a single provider for all of their communications and data networking needs. In 2006, we will be creating a more direct link between our RLEC, CLEC and Internet customer base and the Systems Integration business through joint sales proposals, sales incentive plans, and needs-based proposals that combine *Systems Integration and RLEC, CLEC or Internet services for a custom and differentiated offering.*
- We will continue to make our commitment to customer service a top priority. Our network operations center (“NOC”) provides monitoring, repair and emergency services 24 hours a day, 7 days a week and 365 days a year, which strengthens our relationships with our customers and enhances our competitive position. In an effort to speed up and enhance the customers’ experience when they call in service issues, we implemented a new case management system into the NOC. The system has given us the ability to better manage and prioritize service calls resulting in greater ability to manage the customer’s request. To further enable this, several automated tests were developed and implemented that allow us to analyze every issue that is called in, and within 2 minutes, determine the location of the issue and identify and dispatch the appropriate technician. Our complement of managed services is used for internal monitoring (within the customer’s enterprise), external monitoring (devices visible outside the customer’s enterprise) and comprehensive security assessments and management. Our managed services fills the needs of our customers by allowing them to improve reliability, provide higher levels of service and save money through efficient device management and planning.
- We will offer a broad array of advanced communication services that will enable new modes of communication to become a part of the daily home or business experience. A unified communications strategy will provide integrated applications (e.g. email, voice mail, instant messaging and video conferencing) to provide customers with greater flexibility to select their preferred method of communication.

Operations

RLEC Operations

Our RLEC segment has provided telecommunications services to the RLEC territories since the early 1900s and was one of the first to deploy a 100% digitally switched network. Today, we market our RLEC services, including local telephone, network access, long distance, data and enhanced telephone services, as D&E Communications, in three distinct service territories. Our RLEC strategy is to sell additional communications services, including broadband and enhanced telephone services, and to improve financial performance through operating efficiencies.

We operate in rural and suburban territories totaling 802 square miles, averaging 168 access lines per square mile as of December 31, 2005. Access lines represent revenue producing voice grade equivalent lines connected to the public switch providing dial tone to the customer. As of December 31, 2005, the RLEC served 134,698 access lines. Approximately 72% of these access lines served residential customers.

We offer our customers a broad array of enhanced telephone services including:

- call waiting
- call transferring and call forwarding

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- automatic callback
- video conferencing
- call trace
- call-blocking
- conference calling
- voice mail
- teleconferencing
- DID (direct inward dial)
- caller name and number identification
- distinctive ringing
- simultaneous ringing (in limited areas)

We also offer network access services that provide other telecommunications carriers, such as local exchange carriers, long distance carriers and wireless companies access to our local network facilities for the completion of their calls. Payment for providing these services comes either directly from our customers or from other telecommunications carriers that utilize our networks. Additional interstate access revenues are received from settlement pools administered by the National Exchange Carrier Association, Inc. ("NECA") into which we pay to participate. In addition, we offer private line service and long distance telephone service to our RLEC customers and directory advertising to give customers business service information in addition to telephone number data.

Historically, we have derived a majority of our revenues from the regulated RLEC segments. The RLEC segment accounted for approximately 57% of total 2005 revenues and all of our operating income. Our RLEC revenue is derived primarily from network access charges, local telephone service, enhanced telephone services, directory advertising, private line service and regional toll service. Network access revenue consists of charges paid by wireless companies for access to our network and by long distance companies for access to our network in connection with the completion of long distance telephone calls. Local telephone service revenue consists of charges for local telephone services, including monthly charges for basic local service. Enhanced telephone services revenue is derived from providing special calling features, such as caller ID, call waiting and a telemarketer call-blocking service. Regional long distance revenue is derived from providing regional long distance services to our RLEC customers.

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RLEC access line loss experienced since 2002 is significant, as access lines have traditionally been monitored as an important measure of RLEC performance. Our total RLEC lines decreased by 1.7% in 2003, 2.2% in 2004 and 3.5% in 2005, as a result of various factors that reflect industry trends, including (i) the softening demand for second lines due to customers moving their Internet access to either DSL services provided by us or to cable modems that are provided by competitors, (ii) the use of wireless service in place of second lines and in some cases primary lines and (iii) the move to VoIP service. Additionally, RLEC business lines were reduced by 230 due to the closing of two larger businesses in 2005. Despite the decrease in RLEC access lines, our RLEC revenues have decreased at a slower rate as a result of increases in RLEC basic service fees in August 2005, directory advertising revenue and enhanced services. The growth in DSL revenue in the Internet Services segment has helped to offset decreased RLEC revenue from the loss of second lines. The following table reflects access line trends over the past three years:

	At Or For The Years Ended December 31,		
	2005	2004	2003
ACCESS LINES:			
Residential	97,100	101,366	105,086
Business	37,598	38,241	37,713
Total RLEC	134,698	139,607	142,799
PERCENT OF TOTAL:			
Residential	72.1%	72.6%	73.6%
Business	27.9%	27.4%	26.4%
PERCENTAGE GROWTH:			
Residential	(4.2)%	(3.5)%	(2.1)%
Business	(1.7)%	1.4%	(0.6)%
Total RLEC	(3.5)%	(2.2)%	(1.7)%

CLEC Operations

Our CLEC began operations in 1998 and offers services similar to the RLEC, but primarily targets small and medium-sized business customers within the edge-out markets. We also provide services to residential customers in certain markets, where economically prudent, as part of bundled services with video, high-speed data or long distance. By concentrating the CLEC strategy on markets surrounding the RLEC territories, we are able to leverage our existing human resources including technical and engineering professionals, significant back office infrastructure and network assets. As a result, three of the CLEC markets are within 10 miles, three are within 50 miles, and one is within 100 miles of one or more of the RLEC territories.

We provide our CLEC customers with broadband services, local calling, customized extended local calling, long distance and enhanced telephone services. In addition, we have developed a broadband fiber and coaxial cable network in our State College market to offer bundled services, including cable television, to business and multi-dwelling unit residential customers. We plan to continue to focus primarily on business customers, leverage our existing facilities and construct new facilities when and where it is economically prudent.

Our CLEC revenue is derived primarily from local telephone service, long distance service, network access charges, enhanced telephone services and dedicated data circuits. Local telephone service revenue consists of charges for local telephone services, including monthly charges for basic local service. Long distance revenue consists of charges for both national and regional long distance services, a portion of which is provided on a resale basis. Network access revenue consists of charges paid by long distance companies and other telecommunications carrier customers for access to our network in connection with the completion of long distance telephone calls. Enhanced telephone services revenue is derived from providing special calling features, such as caller ID, call waiting and a telemarketer call-blocking service.

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The number of access lines served by our CLECs has increased from 35,140 access lines as of December 31, 2003, to 38,461 access lines as of December 31, 2004 and 40,796 as of December 31, 2005. We believe that market demand for an alternative communications provider combined with our sales efforts and quality reputation will contribute to continued growth. As of December 31, 2005, approximately 26% of access lines were "On-Net," defined as served entirely on our own facilities. Approximately 64% were "On-Switch," or served through a combination of our facilities and leased facilities and 10% were served completely on lines of another provider, known as "Resale." We provide residential service in our markets but we concentrate our expansion of service to business customers. To help improve profitability, we focus our sales efforts in areas where we can provide service "On-Net" and capital spending is targeted for places where "Resale" and "On-Switch" customers can be converted to "On-Net." The following table reflects our access line growth over the past three years:

	At Or For The Years Ended December 31,		
	2005	2004	2003
ACCESS LINES:			
Residential	3,727	4,298	4,942
Business	<u>37,069</u>	<u>34,163</u>	<u>30,198</u>
Total CLEC	40,796	38,461	35,140
PERCENT OF TOTAL:			
Residential	9.1%	11.2%	14.1%
Business	90.9%	88.8%	85.9%
PERCENTAGE GROWTH			
Residential	(13.3)%	(13.0)%	(9.4)%
Business	8.5%	13.1%	27.9%
Total CLEC	6.1%	-9.5%	20.9%
Percent On-Net or On-Switch	90.0%	89.0%	86.0%

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Internet Service Operations

As part of the strategy to provide a range of data services to customers, we began offering DSL service in the second half of 1999 and began bundling DSL and Internet access services to RLEC and CLEC customers when we launched our Internet service provider, D&E Jazzd, in the fourth quarter of 2000. We began offering VoIP services in May 2005. Our Internet services revenue is derived from dial-up and broadband services and web-hosting services. Internet services are offered to residential and business customers in a geographic region that includes and surrounds the RLEC and CLEC operations. This service is offered entirely on our own facilities in our RLEC territories and primarily on our own facilities in our CLEC markets. Our objective has been to migrate our dial-up Internet customers to our broadband service with DSL. In 2005, 19.9% of our new DSL subscribers upgraded to our broadband service from their previous dial-up service. The fact that we have succeeded in adding Internet service customers at a substantial rate over the past three years demonstrates that our customers value broadband Internet services. We believe the opportunity to provide such services is an important component of our business plan. The following table reflects subscriber growth over the past three years:

	At Or For The Years Ended December 31,		
	2005	2004	2003
DSL	19,795	11,015	7,127
Dial-up	7,959	11,535	12,859
Total Subscribers	27,754	22,550	19,986
Web-Hosting Customers	952	909	814
PERCENT OF TOTAL:			
DSL	71.3%	48.8%	35.7%
Dial-up	28.7%	51.2%	64.3%
PERCENTAGE GROWTH:			
DSL	79.7%	54.6%	26.9%
Dial-up	(31.0)%	(10.3)%	1.6%
Total Subscribers	23.1%	12.8%	9.4%
Web-Hosting Customers	4.7%	11.7%	25.0%

We believe our local presence, focus on customer service and technologically advanced services provide us with a competitive advantage in our markets. While we plan to continue to serve our dial-up Internet access customer base, we also plan to focus our sales efforts on selling our broadband services as part of an integrated communications package. DSL subscribers continue to grow at a rapid pace, increasing by 8,780, or 80%, since December 31, 2004.

Systems Integration Operations

To augment our core voice and data communications services and enhance our position as a provider of integrated communications services, we offer a full range of data and voice solutions for businesses, government agencies and educational institutions. We believe that the complexity of voice communications and data networks has increased the need for these organizations to seek a single provider for all of their communications and networking needs. We believe that the convergence of voice communications and data networks technology further drives this outsourcing trend and increases the need for service providers that have expertise in both voice and data networks. In addition, systems integration services can serve as an entry point to business customers to better position us to capture more of their total communications services spending.

Our Systems Integration revenue is derived from sales of services and equipment that support the design, implementation and maintenance of local and wide area networks and telecommunications systems. Our offerings include VoIP systems, wireless networking solutions, managed services and managed security services

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and consultative information technology ("IT") services. We market these products and services primarily in our RLEC and CLEC service areas, as well as in the eastern Pennsylvania and greater Philadelphia market areas. Our sales team targets businesses, government agencies and educational institutions with comprehensive solutions for their voice and data communication networking needs.

In order to improve the financial performance of this segment, we have begun to streamline our operation by reducing expense and enhancing revenue. Operational expense reductions include rent, wages and a focus on the service component of the Lewisburg market rather than new systems sales. Revenue enhancements include meeting market rates for services and adding managed services to RLEC and CLEC sales proposals. Systems Integration services, when combined with RLEC, CLEC and Internet Services offer our customers a differentiated product offering.

Wireless Operations

Remaining consistent with our focus on wireline communications, we completed the sale of assets of Conestoga Wireless on January 14, 2003. The results of operations of Conestoga Wireless are not reported as discontinued operations due to the continued obligations that we have after the sale related to our guarantees on cell site leases and our responsibility under a Build-to-Suit agreement. Conestoga Wireless reported revenues of \$0.5 million for the 2 weeks before its sale in January 2003. The operating loss was \$0.7 million in 2003.

Upon completion of the sale, D&E received approximately \$10 million in cash and a \$10 million face value secured promissory note issued by Keystone Wireless LLC ("Keystone"). The promissory note requires monthly principal payments for 48 months beginning in January 2005. The note bears interest at the 60-day LIBOR rate plus 5%. As this note receivable is from a highly leveraged entity and the business sold had not generated positive cash flows, we record value to the note when cash recoveries are received. During 2005, we received principal and interest payments of \$1.5 million and \$0.6 million, respectively. During 2004, we received principal and interest payments of \$125,000 and \$0.7 million respectively. During 2003, we received interest payments of \$0.6 million. All scheduled interest and principal payments have been received in full. The note carried certain rights where we could convert a portion or all of the principal balance of the note into equity interests of Keystone. The conversion period began on December 31, 2004 and ended May 1, 2005. We did not exercise any of our conversion rights under this note.

Investments

Our company currently owns a one-third interest in EuroTel, LLC which owns 100% of Pennecom BV, a Netherlands company. Pennecom continues to pursue legal action that it initiated in July 2002 in the United States District Court for the Southern District of New York (See Item 3 Legal Proceedings)

We owned a direct and indirect interest in Pilicka until we sold it on December 19, 2005. We recorded pre-tax income of approximately \$6.4 million as a result of the sale.

We also owned an interest in PenTeleData Limited Partnership I until we sold the interest on February 28, 2005 for \$2.9 million.

Competitive Strengths

Customer Service

We believe there is a high correlation between service quality and the likelihood that our customers will remain with us when presented with a competitive alternative. Our commitment to personalized customer service includes locating call centers in the communities that we serve and providing a single point of contact for service calls by cross-training all customer service personnel in RLEC, CLEC, long distance and Internet service offerings. Call centers provide convenient access for customers to place their orders and make billing inquiries.

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Multiple customer retention measures are employed for larger RLEC business customers and for our CLEC customers who are more likely to be targeted by competitors. These customer retention measures include performance and satisfaction measures, such as monthly customer surveys to ensure customer satisfaction and loyalty. The focus on customer service was evident in the 2005 survey responses, in which 97% of the respondents said that the overall service was good or excellent. Additionally, in areas such as call completion, customer-out-of-service reports and service order completion, our performance consistently exceeds guidelines established by the Pennsylvania Public Utility Commission.

In addition, personnel at our network operations centers coordinate provisioning and maintenance for our customers. Our network is monitored, and repair service is available, 24 hours a day, 365 days a year. Inbound maintenance requests, field personnel dispatches and service order monitoring are all coordinated through this center. Our network operations center also provides us with remote network management, maintenance and repair capabilities, which we believe increases our engineers' productivity and reduces potential service interruptions for our customers.

In an effort to speed up and enhance the customers' experience when they call in service issues, we implemented a new case management system into the NOC. The system has given us the ability to better manage and prioritize service calls resulting in a greater ability to manage the customer's request. To further enable this, several automated tests were developed and implemented that allow us to analyze every issue that is called in, and within 2 minutes, determine the location of the issue and identify and dispatch the appropriate technician.

Sales and Marketing

We instituted a strategic branding awareness campaign, "Delivering Excellence," in the second half of 2003. The branding campaign is a key factor to provide name and brand recognition to the Company to support our business success and sustain a competitive advantage. The "Delivering Excellence" brand recognizes the quality customer service for which we are recognized by our customers. Our employees are immersed in a culture that values and acts upon delivering a positive customer experience which is a vital part of the D&E brand. The quality of the Company's work and our responsiveness in meeting customer needs are critical for the success of the brand and the Company's efforts in achieving successful financial performance.

Convergence is a key element in the future growth of our company. With RLEC line counts declining and increasingly threatened, we must capture additional sources of revenue from each customer. The more customer needs we can address and solve with our communication services, the more effectively we can build a long-term relationship with our customers. The broadband connection into our customers' homes and businesses is the key to delivering voice, data and video services today and advanced IP communication services in the future.

An example of delivering on convergence today for consumers occurs in Union County, Pennsylvania where we have deployed video over RLEC copper facilities. Offering video programming over the existing copper wireline increases the revenue we receive from the customer and provides the means for potential revenue growth within our Company. The bundling of services (e.g. video and DSL with voice) is a key part of our strategy to grow revenue and strengthen our customer relationships by providing increased value with our new bundled services. In addition, offering a full range of services will strengthen our competitive position to compete with cable companies and other competitors who begin to encroach on our traditional telephone service areas.

As we deploy new products and services into our seven "edge-out" markets as part of our CLEC strategy, we believe that we will continue to drive revenue growth. By solving our customers' communication needs, we attempt to demonstrate value and strengthen our relationship with them. Customer testimonials and referrals result from these successes and help drive additional customer opportunities.

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We employ a relationship-based sales and marketing approach. This approach, and a commitment to customer service, builds brand loyalty and increases the effectiveness of sales efforts. We also grow our general brand awareness through corporate and product awareness campaigns that utilize local television, billboard and print ads as well as sponsorship of community events. Corporate spokesmen, Dick Vermeil (former head coach of the Kansas City Chiefs, St. Louis Rams and Philadelphia Eagles) and Joe Paterno (head football coach of Penn State University) also help promote our Company's products and services. With respect to non-RLEC businesses, we support an aggressive integrated marketing communications strategy with targeted direct sales efforts. Customer service representatives are located throughout the service territories and are supported by local sales efforts.

We manage our sales organization to serve both residential and business customers. Our CLEC sales team is focused on businesses that can be served by our "On-Net" facilities. We serve business customers in many markets including healthcare, financial services and educational institutions. Customer service representatives proactively market a complete service portfolio to residential customers through regular calling programs and consultative analyses of customers' services on incoming calls. We have developed up-sell and cross-sell programs in our customer service call centers with sales representatives who are cross-trained in all segments of our business to market the service offerings more effectively. Aggressive monthly sales targets are established for the customer service representatives and their efforts are coordinated with the marketing incentives designed to promote a given service at the same time. Marketing programs and sales initiatives are coordinated with the calling efforts to maximize their effectiveness. In 2005, a focused sales effort centered on broadband Internet services.

The direct sales force targets government and educational institutions, as well as small and medium-sized businesses, and is divided between communication services and systems integration services. Both sales groups make direct calls to existing and prospective customers, make product recommendations and offer a cost comparison of the service package. The sales personnel work closely with the network engineers and systems integrators to design solutions to satisfy customers' needs.

Network Architecture and Operations Support Systems

We were one of the first local exchange carriers in the nation to deploy a 100% digitally switched network. We continue to utilize a fiber-rich network based on digital switching, fiber optic transport technology and host/remote call switching architecture. We operate our own Signaling System 7 network that provides efficient call routing and allows enhanced features to travel across the national telephone network. Our NOC monitors network performance 24 hours a day, 365 days a year and allows us to maintain high network performance standards.

The RLEC has digital host switches in Ephrata, Lititz, Birdsboro and Lewisburg, Pennsylvania and delivers dial tone to an extensive network of remote switches and access nodes that are connected with fiber optic cable. Connection to customers, or the "last mile," is provided over the RLEC's copper or fiber outside plant. The host/remote architecture concentrates network intelligence in the four host offices, enabling the RLEC and CLEC operations to leverage this network and provide short customer loop lengths in our copper cable plant. Short customer loop lengths and the packet information delivery network system facilitate the delivery of advanced broadband services such as DSL. We are capable of providing DSL service to approximately 98% of our RLEC customers.

The CLEC's network strategy is to leverage the core switching architecture of the RLEC network and to own the key elements of the local exchange network. These elements include remote access nodes and the facilities connecting the host switches to the remote access nodes, including both the fiber optic cable and the optical transport electronics. In addition, where economically viable, the CLEC builds copper/fiber distribution facilities between the remote access nodes and customers' premises. The network strategy allows the CLEC to provide high quality and reliable service and helps to minimize customer turnover. In addition, we have one host

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switch and three remote access nodes supporting the broadband fiber network in State College, Pennsylvania. As of December 31, 2005, the CLEC had 90% of its access lines connected to the RLEC switch and 26% of its access lines completely on our network.

The network is supported by computer systems called operations support systems that provide the ability to install service for customers on a short interval basis and to analyze network problems in many instances before the customers are affected. These systems include databases of all RLEC and CLEC customers and the associated facilities such as the fiber and copper cable and the associated central office switching connections that serve them. We also use geographic information systems to map our outside plant cable and associated structure of poles and underground conduit. These same systems allow us to verify quickly the capability of the network for broadband service. We have a system that stores the inventory of central office and transmission equipment that is accessed for the automatic provisioning of customized services for customers. These systems also have monitoring and troubleshooting capabilities to insure the reliability of the network. We are able to interface with the operations support systems of Verizon and Sprint Nextel to assure fast and accurate provisioning of services for the CLEC customers.

Competitive Environment

TA-96 introduced competition among providers of local telephone services enabling customers to switch to services offered by competitive local exchange carriers and cable companies. Several other factors are further increasing competition in local telephone service, including growing customer demand for communications products and services, development of fiber optics and digital electronic technology and legislation and regulations designed to promote competition.

We believe that our RLECs have competitive advantages based on several factors, including the lack of concentration of any large business customers, a strong customer service record and high level of customer satisfaction and the service territories' high cost of facilities-based entry due to low population density and other regulatory factors. Our RLECs experience competition from wireless operators in our service territories, which provide an alternative service to wireline local and long distance services. Wireless competitors include Verizon Wireless, Cingular Wireless, Sprint Nextel, Immix and T-Mobile Wireless. The entry of VoIP competitors such as Vonage and cable companies offering VoIP services have also become a competitive threat.

Our CLEC competes principally with the services offered by the incumbent local exchange carriers, Verizon Communications and Sprint Nextel, and other competitive providers, including other CLECs, inter-exchange carriers, cable television companies, wireless service providers and private networks built by large business customers. The edge-out markets served by our CLEC are served by one or more other CLECs. In addition, in providing long distance service, our RLECs and CLECs are in competition with major carriers such as AT&T, Sprint Nextel and Verizon Communications as well as the wireless companies listed above.

Our Systems Integration business competes with large, regional and national companies that provide a wide variety of services to their customers. These competitors include Morefield, Ecomm, IntelliMark and Weidenhammer Systems Corp. We also compete with numerous smaller service providers. As a result of this competition, we may lose customers or have difficulty acquiring new customers. Barriers to entry to the markets for these services are generally low. As a result, new competitors may enter this market. The existing and new sources of competition place pressure on the pricing of these services.

The market for Internet services is highly competitive. We compete for dial-up and broadband customers with national, regional and local Internet service providers as well as cable companies and direct broadcast satellite companies. These competitors include AOL, EarthLink, MSN, Adelphia Communications, Comcast, Service Electric and Pencor Services. We also compete for business customers with long distance and local communications providers in selling broadband services. The existing and new sources of competition in this market place pressure on the pricing of these services.

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Regulatory Environment

Overview

Our communications services are subject to federal, state and local regulation. We hold various regulatory authorizations for our service offerings. At the federal level, the FCC exercises jurisdiction over all facilities of telecommunications common carriers, such as us, to the extent those facilities are used to provide, originate, or terminate interstate or international communications. State regulatory commissions exercise jurisdiction over such facilities and services to the extent those facilities are used to provide, originate or terminate intrastate communications.

Pursuant to TA-96, state and federal regulators share responsibility for implementing and enforcing the domestic pro-competitive policies introduced by that legislation. In particular, state regulatory agencies have substantial oversight in the provision by ILECs for interconnection and non-discriminatory network access to competitive communications providers. Local governments often regulate the public rights-of-way necessary to install and operate networks, and may require communications services providers to obtain licenses or franchises regulating their use of public rights-of-way.

Federal Regulation

We must comply with the Communications Act of 1934, as amended, which requires, among other things, that communications carriers offer services at just and reasonable rates and on non-discriminatory terms and conditions. Our RLECs also must comply with TA-96. TA-96 encourages competition in local telephone service by requiring ILECs to open their networks and markets to competition. *Because unique market characteristics are typically present in the areas served by RLECs, TA-96 granted an exemption to RLECs from certain interconnection requirements applicable to non-rural ILECs.* This exemption remains in place until an RLEC receives a request for interconnection and the state public service commission determines that the request will not have a negative impact on universal service, will not be unduly economically burdensome, and is technically feasible. State public utility commissions may also grant a suspension of the interconnection requirements under TA-96 to ILECs that have fewer than 2% of the nation's subscriber lines, such as our RLECs. Our RLECs received a temporary suspension of these requirements that expired in January 2003. This temporary suspension has been provided again to our Buffalo Valley RLEC through December 2008 (see Pennsylvania regulation below). Even though our other two RLECs are no longer protected by the temporary suspension, our RLECs will continue to be protected from the more onerous requirements involving the provision of RLEC network facilities at discounted wholesale costs to competitors until the Pennsylvania Public Utility Commission ("PA PUC") also grants a competitor's request to terminate our RLEC's rural exemption. Our RLECs are subject to rate of return regulation at the FCC level. Each RLEC participates in the National Exchange Carrier Association access tariffs and are nationwide average schedule companies for access revenue settlement purposes. NECA filed their annual updated formulas with the FCC to be effective July 1, 2006. This update proposes major reductions to settlements received by larger RLECs, including our three RLECs. It also proposed a two-year transition for implementing the new calculations. Based on our evaluation we estimate the impact, excluding any transition period, would be approximately a \$1 million reduction in 2006 network access revenues for the six-month period beginning July 1, 2006, or an annual decrease of \$2 million. It is estimated that approval of the proposed transition plan to phase in new settlement calculations over a longer period could reduce the 2006 impact by as much as 50% to 75%. The FCC has requested comment from interested parties on NECA's filing. We will not know until June 2006 whether the FCC accepts the revised calculations of NECA or whether the FCC will accept the two-year transition of the reduced settlement amounts.

Pennsylvania Regulation

Our RLECs are subject to regulation by the Pennsylvania Public Utility Commission. In 2001, we entered into an alternative regulatory framework, commonly known as Chapter 30, with the PA PUC for our intrastate operations under which we agreed to meet certain broadband service delivery parameters in exchange for a price

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cap formula, rather than a rate of return regulation. As a result of the alternative regulatory framework, profits are not directly limited by the PA PUC as they were under the former rate of return system of regulation. Instead, our RLECs received the flexibility to increase intrastate rates annually based on inflation less two percentage points. In exchange for the indexed price cap on rates, the RLECs get the benefit of any increase in margin resulting from their ability to reduce operating costs. Our RLECs can also seek to rebalance rates periodically within or between various intrastate service categories, such as local, toll and access. Additionally, our RLECs have the ability to request relief on a dollar-for-dollar basis for certain events deemed outside of their control that result in reduced revenue or increased expenses. On November 30, 2004, the Governor of Pennsylvania signed into law a revised Chapter 30, known as Act 183, that impacts our RLECs. The new law provides additional options to promote broadband deployment in the state and encourage faster rollout of broadband capability to all consumers. Our RLECs have the opportunity to make capital expenditures sooner to have broadband services available to all consumers by December 31, 2008. As an offset to the increased capital expenditure requirements associated therewith, the new law removes the two percentage points inflation offset used to calculate intrastate rates annually. The new law adds other provisions to further the advancement of broadband services to schools in Pennsylvania and provides for a suspension of certain interconnection requirements until December 31, 2008, for companies with less than 50,000 access lines. We currently are capable of providing broadband services as defined by the new law to 98% of our customers. We feel we are well positioned to meet the required 100% threshold by December 31, 2008 and are of the opinion that the benefits of Act 183 outweigh any costs in committing to an earlier 100% threshold. Consequently, our RLECs have filed revised Chapter 30 plans to meet the 100% threshold by December 31, 2008. Our RLECs also pay into and receive intrastate Universal Service Fund ("USF") support from the Pennsylvania USF. See "Promotion of Universal Service."

Our CLEC is also subject to regulation by the PA PUC in relation to intrastate services, including local telephone, regional long distance and network access services. Under the PA PUC's current practices, our CLEC rates and services are generally subject to much less regulatory scrutiny than those of the RLECs in their markets.

The PA PUC must also approve any issuance of stock, incurrence of long-term debt, or acquisition or sale of material utility assets by our RLECs and CLECs. In addition, the PA PUC must approve any change in controlling interest of either our RLECs and CLECs or their holding companies. The PA PUC defines a "controlling interest" as an interest held by a person or group acting in concert, which enables the beneficial holders to control at least 20% of the voting interest in the utility or its parent, regardless of the remoteness of the transaction.

Under TA-96, the PA PUC also has authority to arbitrate any disputes over the terms and conditions of interconnection between our RLECs and CLEC and other telecommunication carriers in our RLEC and CLEC markets, including the prices of various unbundled network elements that our CLEC purchases. The PA PUC has taken a number of actions over the past several years affecting the prices for network elements, as well as the terms and conditions under which these elements are provided. Further decisions by the PA PUC may have a material effect on our CLECs' costs and profitability.

Promotion of Local Service Competition — The Telecommunications Act of 1996

One of the key goals of TA-96 is to encourage competition in local telephone service. To do this, TA-96 provides three means by which communications service providers can enter the local telephone service marketplace:

Resale. ILECs are required to permit new communications service providers to purchase their services for resale to the public at a retail rate or a wholesale rate that is less than the rate charged by the ILEC to their retail customers.

Access to Network Elements. ILECs are required to lease to new communications service providers the various elements in their network that are used to provide local telephone service. The leased parts of the

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ILEC's networks are known as "unbundled network elements." The ILEC must make unbundled network elements available at rates that are based on their forward-looking economic costs.

Construction of New Facilities. New communications service providers may also enter the local telephone service market by building their own facilities.

To facilitate new communications service providers' entry into local telephone markets using one or more of the above three methods, TA-96 imposes on non-rural ILECs the obligation to open their networks and markets to competition. When requested by competitors, non-rural ILECs are required to negotiate in good faith agreements that lay out terms governing interconnection to their network, access to unbundled network elements and discounted resale. Non-rural ILECs also must allow competing carriers to "co-locate", or place their own equipment in the non-rural ILECs' central offices.

As a result of the passage of TA-96, local exchange carriers, including our RLECs, are facing competition in the provision of local telephone and regional long distance services. TA-96 also provides for the codification of the principles of "universal service" and establishes safeguards to foster the provision of communications services in the areas served by ILECs by adopting a federal universal service support fund, or USF. See "Promotion of Universal Service."

TA-96 makes competitive entry into the telecommunications industry more attractive to non-ILECs by, among other things, removing most state and local barriers to competition. In particular, after notice and an opportunity for comment, the FCC may preempt any state requirement that prohibits or has the effect of prohibiting a carrier from providing intrastate or interstate communications services. In addition, TA-96 establishes procedures under which an RBOC can enter the market for long distance services within the area where it provides local telephone service. To date, RBOCs have been granted authority by the FCC to provide such regional long distance services in nearly every state, including Pennsylvania. The provision of regional long distance services by RBOCs permits them to offer "one-stop shopping" of local and long distance services, enhancing their competitive position generally in our RLEC and edge-out markets, should they seek to enter these markets.

Pursuant to TA-96, local telephone companies, including both ILECs and CLECs, are required to: (i) allow others to resell their services at retail rates; (ii) ensure that customers can keep their telephone numbers when changing carriers; (iii) ensure that competitors' customers can use the same number of digits when dialing and receive nondiscriminatory access to telephone numbers, operator service, directory assistance and directory listing; (iv) ensure access to telephone poles, ducts, conduits and rights of way; and (v) compensate competitors for the competitors' costs of completing calls to competitors' customers. Competitors are required to compensate the ILEC for the cost of providing these interconnection services.

TA-96, with certain exceptions described below, requires ILECs to: (i) interconnect their facilities and equipment with any requesting telecommunications carrier at any technically feasible point within their networks; (ii) unbundle and provide nondiscriminatory access to network elements, such as local loops and transport facilities, at nondiscriminatory rates and on nondiscriminatory terms and conditions; (iii) offer their retail services for resale at wholesale rates that would have to be negotiated; (iv) provide reasonable notice of changes in the information necessary for transmission and routing of services over the ILEC's facilities or in the information necessary for interoperability; and (v) provide, at rates, terms and conditions that are just, reasonable and nondiscriminatory, for the physical co-location of equipment necessary for interconnection or access to unbundled network elements at the premises of the ILEC. Competitors are required to compensate the ILEC for the cost of providing these interconnection services.

The FCC ruled that local exchange carriers must port their telephone numbers to requesting wireless carriers, so-called wireline-to-wireless Local Number Portability ("LNP"). Local exchange carriers operating in the country's largest urban areas were required to make LNP capability available to wireless carriers beginning

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November 24, 2003. Rural carriers, including our RLECs, outside the 100 largest Metropolitan Statistical Areas had to port their numbers to wireless carriers beginning May 24, 2004, or within six months of receiving a bona fide request, whichever was later. As of the date of this filing, we have received requests to port numbers from two wireless companies. The FCC still has under consideration a number of technical and cost recovery issues associated with deployment of LNP.

At its February 20, 2003 public meeting, the FCC voted on rules concerning ILECs' obligations to make elements of their networks available on an unbundled basis to new entrants. The Third Report and Order ("the TRO") was published on August 21, 2003. According to the TRO, ILECs would not be obligated to give competitors unbundled access to broadband and fiber lines that the ILEC's deploy in the future to provide broadband service. The FCC established an impairment standard to determine whether ILECs must open elements of their systems to competitive providers. The standard is whether economic and operational impairment exists in a particular market necessitating the unbundling of elements of the ILECs' systems for competitive providers. The state public utility commissions were tasked with conducting proceedings to apply the stated impairment standards to their specific markets. The PA PUC undertook its proceedings and was in the final decision stage when, on March 2, 2004, the United States Court of Appeals for the District of Columbia Circuit invalidated significant portions of the TRO. Most relevantly, the Appeals Court ruled that the FCC had delegated too much authority to the states and had not established sufficient bases for its order to unbundle mass market switches and transport facilities. Further, the Appeals Court affirmed the FCC's decision not to require unbundling of hybrid loops, fiber-to-home loops and line sharing, but partially remanded the FCC's rules on enhanced extended loops ("EELs") used for provision of long distance service. The Court temporarily stayed its vacating of the rules until the later of 60 days or the denial of any petition for rehearing. In June 2004, the Department of Justice and the FCC decided not to seek review of the D.C. Circuit's decision. In response, on August 20, 2004, the FCC released interim rules for unbundling and initiated a proceeding to review and revise its unbundling rules. On December 15, 2004, the FCC adopted rules limiting ILEC unbundling obligations in order to provide incentives for both ILECs and CLECs to invest in the telecommunications market in a way that best allows for innovation and sustainable competition. The new rules eliminated mass market switching as an unbundled network element and limited the availability of high-capacity loops and dedicated interoffice transport as unbundled network elements to CLECs. On February 4, 2005, the FCC published an order on remand regarding the requirements of Section 251(c)(3) of TA-96. The Order imposes unbundling obligations in a more targeted manner where requesting carriers have undertaken their own facilities-based investments and will be using unbundled network elements in conjunction with self-provisioned facilities. The FCC clarified their impairment standard with regards to Dedicated Interoffice Transport and High Capacity loops and reaffirmed that ILECs have no obligation to provide CLECs with unbundled access to mass market local circuit switching. The FCC adopted a 12-month plan for competing carriers to transition away from use of unbundled mass market local circuit switching. The new rules will have an adverse impact on our CLEC because it purchases unbundled switching from ILECs. Because these rules are subject to a pending court challenge, we are unable at this time to determine the impact of the new rules changes on our CLEC. ILECs and CLECs may now turn to tariffs and/or market-based contract pricing to continue to purchase the vacated unbundled elements for the immediate future.

Congress specifically recognized that the movement towards increased competition under TA-96 requires accommodation for the different market characteristics of areas served by RLECs. For these areas, TA-96 included provisions which anticipate that the public interest may be best served by exempting RLECs from the more burdensome interconnection obligations. RLECs' characteristics make these markets much more vulnerable to target market entry (i.e. "cream skimming") by new entrants. TA-96 recognized that selective customer targeting in areas served by RLECs could have an adverse impact on universal service and the overall public interest.

Congress recognized that interconnection requirements must be carefully constructed, modified or suspended in order to ensure that new entrants targeting primarily lower cost, higher volume customers do not leave the RLECs with only high cost, low volume customers from whom to recover relatively unchanged network costs. Accordingly, TA-96 provides RLECs, including our RLECs, with an automatic blanket exemption

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("rural exemption") from certain interconnection requirements. Therefore, an RLEC is exempt from the more onerous interconnection requirements until that RLEC receives a bona fide request for interconnection and the state public service commission determines that the request is not unduly economically burdensome, is technically feasible, and is consistent with universal service principles.

Under TA-96, ILECs with fewer than 2% of the nation's subscriber lines, such as our RLECs, may request from state PUCs suspension or modification of any or all of the requirements described above. A PUC may grant such a request if it determines that such suspension or modification is consistent with the public interest and necessary to avoid a significant adverse economic impact on communications users and to avoid imposing a requirement that is technically unfeasible or unduly economically burdensome. Pursuant to TA-96, our RLECs, along with other RLECs in Pennsylvania, received a temporary suspension of specific interconnection requirements. This suspension expired on July 10, 2002; however, we were granted an interim extension until January 15, 2003, while the PA PUC contemplated our request for another three-year extension. This request was subsequently denied by the PA PUC. The passage of Act 183 legislation now provides an automatic suspension of the more onerous interconnection requirements until December 31, 2008, for all companies that have under 50,000 access lines and which have agreed to accelerate universal broadband deployment. This includes our Buffalo Valley RLEC. The rural exemption under TA-96 is still in effect for our other two RLECs, so that we are still exempt from the more onerous interconnection requirements until we receive a bona fide request for interconnection and the PA PUC determines that the request is not unduly economically burdensome, is technically feasible, and is consistent with universal service principles. In addition, according to the recent Appeals Court decision on the FCC's TRO, our RLECs may not have to unbundle all elements of our system to competitors, including our broadband and DSL deployment and some of our switches. However, the denial of the renewal of our temporary suspension may put two of our RLECs in a position of having to face a request for removal of their rural exemption and provide interconnection to other providers without adequate compensation, cause us to incur administrative and regulatory costs as a result of administrative proceedings to determine whether the provider requesting interconnection has met its burden under the rural exemption of TA-96, cause our operating costs to increase as a result of having to make such interconnections, and at the same time cause us to suffer a loss of customers to such competitive providers.

To the extent our CLEC seeks to enter the local telephone service business in other RLEC territories, we could encounter difficulties in obtaining interconnection with those RLECs, particularly if those RLECs are entitled to the same protections we enjoyed in our RLEC territories. In particular, in those circumstances, we might be unable to obtain access to the RLECs' networks, which could significantly detract from our ability to implement our CLEC strategy in those areas.

Even if an ILEC in a territory that we wished to enter were not entitled to such protections, we could nonetheless be unable to obtain interconnection on favorable terms. The FCC has issued rules implementing the interconnection and resale provisions of TA-96, but those rules have been, and continue to be, subject to administrative and judicial appeals. Thus, there is continuing uncertainty about individual rules governing pricing of interconnection and unbundled network elements, and the terms and conditions of interconnection agreements. This may make negotiating these agreements more difficult and time-consuming. It also could require renegotiations of relevant provisions of existing interconnection agreements or subject them to additional court or regulatory proceedings.

Promotion of Universal Service

The Federal Universal Service Support Fund ("USF") and the Pennsylvania State Universal Service Fund ("PA USF") pay our RLECs from their funds to support the cost of our operations in rural markets. Our three RLECs paid in approximately \$350,000 to the PA USF and received support payments of approximately \$2,526,000 in 2005 from this fund. In addition, the three RLECs received approximately \$7,096,000 from the Federal USF. The RLECs also contributed to the fund, but this expense is recovered in full through the NECA pooling process.

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Newly codified universal service principles have been implemented by the FCC. One of the implemented principles provides that USF funds will be distributed only to carriers that are designated as Eligible Telecommunications Carriers ("ETCs") by the PA PUC. Our RLECs have been designated as ETCs pursuant to TA-96. However, under TA-96, competitors could obtain the same support payments as we do if the PA PUC determined that granting such support payments to competitors would be in the public interest. If such universal service support payments were to become available to potential competitors, our RLECs might not be able to compete as effectively or otherwise continue to operate as profitably as they have historically. RLECs will receive USF payments pursuant to existing mechanisms for determining the amounts of such payments with some limitations, such as on the amount of corporate operating expense that can be recovered from the USF. On October 6, 2005, our CLEC filed for ETC status. This filing is still pending before the PA PUC.

In 2004, the Federal-State Joint Board on Universal Service ("Joint Board") provided recommendations to the FCC addressing the growth of the USF, eligibility criteria for receipt of funds, and the cost basis for fund payment to Competitive Eligible Telecommunications Carriers. On June 8, 2004, the FCC issued a Notice of Proposed Rulemaking seeking comment on a recommended decision of the Joint Board. The Joint Board recommended that the FCC adopt permissive federal guidelines for states to consider in proceedings to designate competitive carriers as eligible to receive universal service support, and it further recommended that the FCC limit the scope of high-cost support to a single connection that provides a subscriber access to the public telephone network. On August 16, 2004 and August 17, 2005, the Joint Board issued notices seeking comments on several issues relating to the high-cost portion of federal universal service for rural carriers and the appropriate rural mechanism to succeed the five-year plan that the FCC created in 2001. Issues under consideration include: the appropriate cost basis for determining support levels for rural carriers, whether to modify the definition of rural carrier and the amount of universal support available for acquired exchanges. We are unable to predict whether and to what extent we would be eligible to receive any federal support if the FCC makes some or all of the modifications under consideration in these proceedings. In addition, Congress may address universal service issues in legislation, but we cannot predict the occurrence, timing or effects of such legislation. However, the federal high-cost support we receive today is only one component of the total federal USF support that we receive and constitutes less than one percent of our total revenues.

Access Charge Reform

For the year ended December 31, 2005, approximately 50% of our RLECs' revenues came from network access charges, which are paid to us by end users and intrastate and interstate long distance carriers for originating and terminating calls in the territory served by our RLECs. The amount of network access revenues that we receive is calculated based on guidelines set by federal and state regulatory bodies, and such guidelines could change at any time. Both the PA PUC and the FCC have made and are continuing to consider various reforms to the existing rate structure for charges assessed on long distance carriers for connection to local networks. These reforms are designed to move these network access charges, over time, to lower rate levels and structures. These changes will reduce access charges and could shift recovery to end-user customers rather than long distance carriers. As a result, the aggregate amount of network access charges paid by long distance carriers to access providers, such as our RLECs, will likely decrease.

In July 2000, the PA PUC created a state universal service fund accompanied by intrastate regulatory access reform, resulting in revenue shifts for our RLECs among local telephone, long distance and network access service categories. On November 9, 2001, the FCC released an order changing its interstate access charge rules and universal service support system for rate-of-return RLECs. The new rules change the sources of funding under the average schedule formulas, but not the amounts paid to participants. These modifications include a reduction in access charges to long distance companies, an increase in subscriber line charges to local service customers, and the creation of a universal funding mechanism funded by all telecommunications carriers.

In February 2004, the FCC took additional steps to provide rate-of-return carriers with greater flexibility to respond to changing marketplace conditions by resolving certain outstanding issues in the Multi-Association

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Group proceeding. The FCC modified the "all or nothing" rule to permit rate-of-return carriers to acquire price cap exchanges and convert them to rate-of-return regulation without the need for a waiver. The FCC also allowed rate-of-return carriers the ability to geographically de-average access transport and special access charges to respond to competitive conditions in their marketplaces. Finally, the FCC merged long term support into interstate common line support to replace implicit support in access charges. Our RLECs are not impacted at this time by these changes.

On October 5, 2004, the Intercarrier Compensation Forum ("ICF"), a diverse group of telecommunications industry participants representing ILECs, CLECs, long distance companies, rural telephone companies and wireless providers, submitted to the FCC a comprehensive plan for reforming the current system of rates that telecommunications companies charge each other for network access and fees to ensure universal service in the United States. Shortly afterwards, several other entities filed their versions of proposed intercarrier compensation reform plans with the FCC. On February 10, 2005, the FCC released a notice seeking comment on seven comprehensive reform proposals submitted by the industry and others in the rulemaking. Among the questions the Commission will examine is the effect any change will have on consumers and the universal service fund, which helps provide affordable service for rural and low income Americans. The Commission said it would be "particularly receptive" to any plan that offers expanded choices and lower rates to rural consumers. The FCC has not yet acted on this notice, and there is no guarantee that a final order addressing potential modifications to the current access charge system will be issued in 2006, and we are unable to address the potential outcome with any degree of certainty.

Communications Assistance for Law Enforcement Act

Under the Communications Assistance for Law Enforcement Act ("CALEA") and related federal statutes, we are required to provide law enforcement officials with call content and call identifying information under a valid electronic surveillance warrant and to reserve a sufficient number of circuits for use by law enforcement officials in executing court-authorized electronic surveillance. We believe we are in compliance with current laws and regulations. On August 4, 2004, in response to a joint petition filed by the Department of Justice, Federal Bureau of Investigation, and the Drug Enforcement Administration, the FCC launched a Notice of Proposed Rulemaking proposing a thorough examination of the appropriate legal and policy framework of CALEA. In this proceeding, the FCC will examine issues relating to the scope of CALEA's applicability to services such as broadband Internet access, as well as implementation and enforcement issues. We cannot predict the eventual outcome of this proceeding or what compliance with any rules adopted by the FCC may cost.

Voice Over Internet Protocol

The further development of VoIP is changing voice communication to a packet data transmission process. This new process will enable Internet service providers ("ISPs") and new start-up companies the ability to utilize existing loop cable facilities without incurring the cost of the cable loop. Cable companies, ISPs and new start-up companies will be able to compete with telephone companies for voice transmission services and phone features like voicemail and unified messaging. Furthermore, there is not consistent regulation of VoIP offerings at this time, placing VoIP at a possible regulatory advantage over telephone services. The FCC has ruled that VoIP services are not telecommunications services and should be subject to minimal regulation. In a related matter, however, the FCC has denied AT&T's petition claiming that its service is an information service not subject to access charges. Additionally, the FCC has issued a decision that IP-enabled services, such as VoIP, are not subject to traditional state public utility regulation. The decision makes clear that the FCC has the responsibility and obligation to decide whether certain regulations apply to IP-enabled services. The FCC has yet to decide what compensation these services must pay to originate calls to or terminate calls from the traditional public switched telephone network. In addition, on May 19, 2005, the FCC adopted an Order requiring the provision of 911 services by VoIP providers that connect their customers to the public switched network. All interconnected VoIP providers must notify customers regarding the provisions of 911 service and certify to the FCC that existing customers have been informed and that they acknowledged receipt of such information. Our ISP is in full compliance with the FCC requirements and we are working to make 911 service available everywhere we

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wish to offer the service. The cost to provide 911 connectivity in all potential locations is still under investigation by the Company. In addition to regulation of 911 service, on September 23, 2005, the FCC issued a Report and Order holding that the requirements to make networks available for electronic surveillance by law enforcement agencies under the federal CALEA applies to facilities-based broadband Internet access providers and a broad category of VOIP providers. It is not possible at this time to predict how the FCC's recent action will affect the Company. While it may be easier for the Company to comply with new CALEA requirements than other VOIP providers, the FCC left to a future Order the task of defining the specific capabilities that carriers will have to provide to law enforcement agencies, and the method for recovering costs for providing those capabilities. In addition, the FCC issued a Notice of Proposed Rulemaking seeking comments as to whether small and rural providers of facilities-based broadband Internet access providers should be exempt from CALEA requirements.

Cable Modem and DSL Broadband Services

In 2005, the Supreme Court upheld an FCC ruling that broadband cable modem service provided by cable operators is properly classified as an information service, rather than as a telecommunications service. As such, our cable TV operation will not have to provide open access to its cable modems. In response to the Court's action, on September 23, 2005, the FCC released a Report and Order in which it determined that the provision by telephone companies of wireline broadband services such as DSL, constitutes an information service, rather than a telecommunications service. Previous to this ruling, FCC policies and rules required facilities-based telephone company providers of DSL to offer the wireline transmission component of DSL separately to competitors, on a common carrier basis. The FCC's recent ruling eliminated this requirement to share such transmission capacity with competitors, subject to a one year transition period wherein existing offerings of such transmission capacity must be maintained, on a "grandfathered" basis, to purchasers unaffiliated with the telephone company. The FCC ruled that while facilities-based telephone companies are not required to offer broadband wireline transmission capacity to their competitors, they are permitted to do so if they choose, and may make such offerings on either a common carrier or a non-common carrier basis. The FCC's ruling appears at this time to be deregulatory and to be intended to put facilities-based telephone company providers of DSL in regulatory position similar to that of cable TV providers of cable modem service. The ruling also provides that it does not alter the rights of competitors under Section 251 of the Communications Act to purchase "unbundled network elements" including the purchase of unbundled loops to provide their own DSL service. However, our RLECs are not required to provide these unbundled network elements as long as their rural suspension continues in existence. A decision has not been made as yet whether cable modem providers will be required to contribute to the federal USF as telephone company DSL providers do or whether telephone company DSL providers will no longer have to contribute to the federal USF on the basis of their DSL revenue. It is not possible at this time to predict how the FCC's recent action will affect the Company, including the impact on the competitive position of the Company in the provision of DSL services, and the impact on payments into the federal USF.

Potential Internet Regulatory Obligations

In connection with our Internet access offerings, we could become subject to laws and regulations as they are adopted or applied to the Internet. There is currently only a small body of laws and regulations applicable to access to or commerce on the Internet. As the significance of the Internet expands, federal, state and local governments may adopt rules and regulations, or apply existing laws and regulations to the Internet. To date, the FCC has treated Internet service providers, or ISPs, as enhanced service providers, rather than common carriers, and therefore ISPs are exempt from most federal and state regulation, including the requirement to pay access charges or contribute to the federal USF. We cannot predict the nature of such future regulations or their impact on our business.

Employees

We had 640 employees as of December 31, 2005, of which 76 employees are covered by a collective bargaining agreement. This agreement expires on July 12, 2009.

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Item 1A. Risk Factors

The convergence of voice and data communications technologies could eliminate our competitive advantages and may, in fact, put us at a competitive disadvantage. We may experience increased competitive pressures, which could have a negative effect on our revenues and earnings.

The convergence of voice and data communication technologies is changing the communications industry. For several years, telephone and cable companies have been able to provide data transmission, with telephone companies having the advantage in voice and cable companies having the advantage in video. Technology is reducing those advantages. The development of VoIP is changing voice communication to a packet data transmission process. This enables cable companies, as well as ISPs and new start-ups who require minimal capital investment, to compete with telephone companies for voice services and phone features like voicemail and unified communications. These developments have placed our core telephone business at risk, although also enabling us to compete in the provision of cable TV services.

Adding to the complexity of the competitive environment, wireless offerings in voice and data are becoming increasingly competitive; and technology has been developed that could enable electric power transmission companies to compete in the communications industry in the future. Service offerings of telephone, cable and electric power companies in voice, data and video may be similar, while wireless is a significant provider in voice and data.

It is basic policy of the FCC and the Pennsylvania Public Utility Commission ("PUC") to encourage competition in the communications industry. The limited suspension that we held until January 2003 from certain interconnection requirements of the Telecommunications Act of 1996 has been discontinued, although legislation enacted in Pennsylvania in the fourth quarter of 2004 provided a continued limited suspension to our Buffalo Valley RLEC through December 31, 2008. These developments mean that two of our RLECs could be required to allow competitors to have access to our customers by our competitors seeking the removal of our rural exemption, entering our territory and using our facilities through interconnection agreements to provide local services. Local cable TV companies may use their own facilities and apply to be licensed as a facilities-based CLEC within our franchise territory in order to attempt to qualify for number portability. This would enable our existing telephone customers to switch to VoIP services provided by the cable TV companies and still retain the same telephone numbers, thus making the transfer of local telephone services to VoIP far more convenient to the customer. Service Electric Telephone Company, LLC, filed on September 2, 2005 with the PUC to be a facilities-based CLEC competitor in our Conestoga RLEC territory. In addition, CORE Communications, Inc ("CORE") filed an amended application on August 19, 2005 with the PUC to be a facilities-based CLEC providing service in our RLEC territories. On January 25, 2006, CORE served our three RLECs with their Petition for Arbitration. Included in Appendix 2 of their filing is a request seeking a termination of the rural exemption for the limited purpose of permitting the interconnection standards to apply to any direct interconnection between our three RLECs and CORE. We are actively engaged in these filings and will be working with both CLECs to develop interconnection agreements to be filed with the PUC.

In areas served by our CLEC, the incumbent carrier, Verizon, enjoys certain business advantages, including its size, financial resources, brand recognition and network connection to virtually all of our customers and potential customers in those areas. Similarly, in areas where we do or may provide video services, the incumbent cable operators enjoy certain business advantages, including their size, financial resources, brand recognition, and ownership of or superior access to programming.

As an integrated communications provider, we face competition from:

- competitive local exchange carriers, including TelCove, Commonwealth Telephone Enterprises, Choice One and XO Communications;
- wireless service providers, including Cingular Wireless, Verizon Wireless, Sprint Nextel, Immix and T-Mobile Wireless;

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- internet service providers, including AOL, EarthLink and MSN;
- cable television companies, including Adelphia, Comcast, Pencor Services, Atlantic Broadband LLC, Service Electric and CATV Service, Inc.;
- voice over Internet protocol ("VoIP") providers, including Vonage, AT&T and Verizon;
- providers of communications services, such as long distance services, including AT&T, Sprint Nextel and Verizon Communications;
- systems integration providers, including Morefield, Ecomm, IntelliMark and Weidenhammer Systems Corp.; and
- electric power companies as possible competitors in the future.

Many of our competitors are, or are affiliated with, major communications companies. These competitors have substantially greater financial and marketing resources and greater name recognition and more established relationships with a larger base of current and potential customers than we. Accordingly, it may be more difficult to compete against these large communications providers. In addition, we cannot assure that we will be able to achieve or maintain adequate technology to remain competitive. Our continued addition of fiber to enhance our broadband capacity may be more difficult as a result of our indebtedness than for our competitors. Accordingly, it may be difficult to compete in any of our markets.

We are subject to a complex and uncertain regulatory environment that may require us to alter our business plans.

The United States communications industry is subject to federal, state and local regulations that are continually evolving. As new communications laws and regulations are issued, we may be required to modify our business plans or operations, and we may not be able to do so in a cost-effective manner. Federal and state regulatory trends toward a more competitive market place through reduced competitive entry standards are likely to have negative effects on our business and our ability to compete. In this regard, the regulatory environment governing ILEC operations has been and will likely continue to be very liberal in its approach to promoting competition and network access, which may increase the likelihood of new competitors offering similar services in our service areas. The introduction of new competitors could have a negative effect on our RLEC operating results, yet at the same time present operating benefits to our CLEC business.

Prices for RLEC's interstate services, consisting primarily of subscriber line charges and access charges for interstate and international toll calls, are regulated by the FCC based on the "average schedule" formulas proposed by NECA. Removal of the RLECs from the NECA average schedules could result in a significant revenue loss. Changes in the average schedule formula amounts developed by NECA and implemented annually in July could have a negative effect on the RLEC's future revenues. NECA filed their annual updated formulas with the FCC to be effective July 1, 2006. This update proposes major reductions to settlements received by larger RLECs, including our three RLECs. It also proposed a two-year transition for implementing the new calculations. Based on our evaluation we estimate the impact, excluding any transition period, would be approximately a \$1 million reduction in 2006 network access revenues for the six-month period beginning July 1, 2006, or an annual decrease of \$2 million. It is estimated that approval of the proposed transition plan to phase in new settlement calculations over a longer period could reduce the 2006 impact by as much as 50% to 75%. The FCC has requested comment from interested parties on NECA's filing. We will not know until June 2006 whether the FCC accepts the revised calculations of NECA or whether the FCC will accept the two-year transition of the reduced settlement amounts.

Our RLECs held a limited suspension from certain interconnection requirements with competitors, which expired in 2003. The suspension had protected our RLEC markets by excluding us from requirements to allow competitors to have access to our customers by relying upon our facilities. Since the Pennsylvania Public Utility

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Act, as amended in November 2004, provides a suspension only to RLECs that have under 50,000 lines and which have agreed to provide universal broadband availability by December 31, 2008, two of our three RLECs may see competitors seeking to remove our rural exemption for the purposes of entering our territory and using our services and facilities through interconnection agreements to provide competitive services. The introduction of new competitors could result in the loss of customers and have a negative effect on our revenues and earnings. Although our two RLECs have lost their suspension from certain interconnection requirements, changes at the federal level as noted below have provided some relief permitting our RLECs to offer only certain services, affording them a greater ability to recover their investment costs.

The PUC is currently considering changes in intrastate switched access rates and intrastate USF reform for ILECs in Pennsylvania. The proceeding, which began in December 2004, addresses the rates that our RLECs charge to long distance carriers for intrastate toll calls that originate or terminate on our RLECs' local telephone lines. Our RLECs also receive funding from the Pennsylvania USF, which could be affected by the PUC's investigation. At this time, we cannot predict either the timing or the outcome of the PUC's proceeding.

The FCC has made and will continue to make regulatory changes that will affect both our RLEC and CLEC operations. On December 15, 2004, the FCC adopted rules limiting ILEC unbundling obligations in order to provide incentives for both ILECs and CLECs to invest in the telecommunications market in a way that best allows for innovation and sustainable competition. The new rules eliminate mass market switching as an unbundled network element and limit the availability of *high-capacity loops and dedicated interoffice transport as unbundled network elements to CLECs*. While beneficial to our RLECs, our CLEC interconnects with and uses other telephone companies' networks to access certain of their customers in order to provide service, such as voice, and data communications and DSL. Our CLEC depends, in certain circumstances, upon the technology and capabilities of other telephone companies as well as the quality, availability and maintenance of the facilities of those telephone companies. We must also maintain efficient procedures for ordering, provisioning, maintaining and repairing facilities from these other telephone companies. We may not be able to obtain facilities and services of satisfactory quality from other telephone companies, or on satisfactory terms and conditions, in which case we may experience delays in the growth of our CLEC networks and the degradation of the quality of our service to customers. The new rules may have an adverse impact on our CLEC because it purchases unbundled switching from ILECs. Although Verizon has indicated that they will continue to offer unbundled switching on a commercial contract basis, our CLEC will receive less favorable terms and conditions in the commercial contract than they received under the prior FCC mandated contracts.

The FCC, on February 10, 2005, initiated a proceeding to develop a unified intercarrier compensation regime. This proceeding will affect our RLECs, CLECs, long distance and VoIP operations. The FCC is considering various plans that have been submitted to the FCC and has solicited comments from the public concerning those proposals. Most, if not all of these proposals, if adopted would affect the intercarrier compensation revenues and expenses as well as the USF funding that our RLECs receive. The rule changes that result from this proceeding could have a material effect on our revenues, expenses and earnings. *Until the FCC adopts a specific proposal, it is impossible to predict how changes will affect our company.*

The Supreme Court has upheld an FCC ruling that broadband cable modem service provided by cable operators is properly classified as an information service rather than a telecommunications service. In response to the Court's action, on September 23, 2005, the FCC released a Report and Order in which it determined that the provision by telephone companies of wireline broadband services, such as DSL, constitutes an information service, rather than a telecommunications service. Previous to this ruling, FCC policies and rules required facilities-based telephone company providers of DSL to offer the wireline transmission component of DSL separately to competitors on a common carrier basis. The FCC's recent ruling eliminated this requirement to share such transmission capacity with competitors, subject to a one year transition period *wherein existing offerings of such transmission capacity must be maintained, on a "grandfathered" basis, to purchasers unaffiliated with the telephone company*. The FCC ruled that while facilities-based telephone companies are not required to offer broadband wireline transmission capacity to their competitors, they are permitted to do so if

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they choose, and may make such offerings on either a common carrier or a non-common carrier basis. The FCC's ruling appears at this time to be deregulatory and to be intended to put facilities-based telephone company providers of DSL in regulatory position similar to that of cable TV providers of cable modem service. However, the ruling also provides that it does not alter the rights of competitors under Section 251 of the Communications Act to purchase "unbundled network elements" including the purchase of unbundled loops to provide their own DSL service. It is not possible at this time to predict how the FCC's recent action will affect the Company, including the impact on the competitive position of the Company in the provision of DSL services, and the impact on access charge revenue settlements with NECA.

The FCC has yet to significantly regulate VoIP offerings, maintaining regulatory uncertainty while placing VoIP services at a regulatory advantage over our RLEC legacy telephone services. Currently, two recent FCC rulings have defined the regulatory status of VoIP as an information service subject to minimal regulation by the FCC rather than as a telephone service subject to state commission regulation. The FCC has issued a Notice of Proposed Rulemaking to broadly investigate the appropriate regulatory treatment of VoIP services. It is unknown at this time when the FCC will act on this proposal or what effects any changes may have on the results of our operations or financial conditions. The FCC has ordered strict requirements for the provision of 911 services by VoIP providers. All interconnected VoIP providers must notify customers regarding the provisions of 911 service and certify to the FCC that existing customers have been informed and that they acknowledged receipt of such information. Our ISP is in full compliance with the FCC requirements and we are working to make 911 service available everywhere we wish to offer the service. We are still investigating the cost to provide 911 connectivity in all potential locations. In addition to regulation of 911 service, on September 23, 2005, the FCC issued a Report and Order holding that the requirements to make networks available for electronic surveillance by law enforcement agencies under the federal Communications Assistance for Law Enforcement Act ("CALEA") applies to facilities-based broadband Internet access providers and a broad category of VoIP providers. It is not possible at this time to predict how the FCC's recent action will affect us. While it may be easier for us to comply with new CALEA requirements than other VoIP providers, the FCC left to a future Order, the task of defining the specific capabilities that carriers will have to provide to law enforcement agencies, and the method for recovering costs for providing those capabilities. In addition, the FCC issued a Notice of Proposed Rulemaking seeking comment as to whether small and rural providers of facilities-based broadband Internet access services should be exempt from CALEA requirements.

The FCC has also enacted changes to certain technical rules that would foster broadband deployment using the capabilities of the nation's power grid.

All of these developments may result in an even more highly competitive environment in which utility companies are very likely to be in direct competition with telephone companies and cable TV operators in many locations. This development could cause telephone companies to lose their competitive edge in their territories and, consequently, result in significant inroads into their core telephone/voice business.

Our indebtedness could restrict our operations.

As of December 31, 2005, we had approximately \$215.5 million of total indebtedness, including current maturities. We refinanced our indebtedness in March 2004 and further amended our credit facility in November 2004. The effect of the refinancing was to lower the interest rates on our indebtedness, provide greater flexibility in our financial covenants and spread out the amortization of principal. The refinancing also lifted restrictions on the expansion of our CLEC edge-out market and eliminated the requirement of the prior loan agreement that excess cash flow be applied to prepayments of principal. This new structure, pursued to manage our balance sheet in order to better achieve our business plan, decreases the risks associated with our indebtedness.

However, our indebtedness could still restrict our operations because we will use a substantial portion of our cash flow from operations, if any, to pay principal and interest on our indebtedness, which will reduce the funds available for working capital, capital expenditures, acquisitions and other general corporate purposes.

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Additionally, our level of indebtedness may make us more vulnerable to economic or industry downturns and competitive pressures. The agreements governing our indebtedness contain covenants imposing financial and operating restrictions on our business. These restrictions may limit our ability to take advantage of potential business opportunities as they arise and adversely affect the conduct of our business. These covenants place restrictions on our ability and the ability of our subsidiaries to, among other things:

- incur more indebtedness;
- pay dividends over \$10 million annual limit, redeem or repurchase our stock or make other distributions;
- make acquisitions or investments;
- use assets as security in other transactions;
- enter into transactions with affiliates;
- merge or consolidate with others;
- dispose of assets or use asset sale proceeds;
- create liens on our assets; and
- extend credit.

The Systems Integration Segment could be affected by the concentration of business among a few major customers.

The sale of equipment and services in the Systems Integration business is dependent upon the willingness of companies to invest in improvements in their information and communications systems. This business is more concentrated among a few major customers than other segments of our business and may be affected by the economic conditions in our customers' business sectors.

We have continuing involvement in the Conestoga Wireless segment after its sale, which may adversely affect the continuing operations of the business.

In connection with the acquisition of Conestoga, we committed to a plan to sell the assets of Conestoga's wireless segment. The sale was completed on January 14, 2003. We have continuing involvement after the sale as a result of our continued guarantees on cell site leases. This obligation could restrict our operations by reducing the funds available for working capital, capital expenditures, acquisitions and other general corporate purposes.

Item 1B. *Unresolved Staff Comments*

None

Item 2. *Properties*

Our properties consist primarily of administration buildings, central office switch facilities, telephone lines and related equipment and other land and buildings related to telephone operations. Our major owned facilities include our corporate headquarters and central office switching facility, totaling approximately 113,700 square feet in Ephrata, Pennsylvania; an office building including our network operations center totaling 80,100 square feet in Brownstown, Pennsylvania; and twenty other buildings that serve a variety of functions including offices, warehouses, garages, vehicle service center and switching facilities, totaling approximately 175,300 square feet. We lease 32,600 square feet for use as office space. We own more than fifty other smaller locations totaling over 68,500 square feet that are used for various purposes such as housing switching equipment. All our assets are maintained and upgraded on a continuing basis to assure quality service for our customers.

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We have transmission facilities referred to as our outside plant, consisting of cables, wires, terminals and necessary supporting structures such as poles, conduit and manholes. Our cables are installed on poles, underground conduit or directly buried in the earth. In addition to plant and equipment that we wholly own, we utilize poles, towers and cable and conduit systems wholly-owned by, or jointly-owned with, other entities.

We were one of the first local exchange carriers in the nation to deploy a 100% digitally switched network, which enables us to economically provide a broad portfolio of advanced voice and data communications services. Our network includes 1,170 route miles of fiber in a pattern of multiple rings, which provide a high level of redundancy in the event of a service failure. Our primary network operations center further leverages network design with remote network management, maintenance and repair capabilities to pinpoint network problems, minimize technician deployment and improve operating efficiency. Our network is monitored 24 hours a day, 365 days a year and continual upgrades to network elements ensure the uninterrupted delivery of quality services to customers.

Item 3. *Legal Proceedings*

In July 2002, EuroTel's subsidiary PenneCom, commenced an action in the United States District Court for the Southern District of New York against an investment bank and an individual. The action is currently pending in United States District Court. PenneCom's Amended Complaint asserted claims under Polish, Dutch and New York law against the defendants for their alleged tortious inducement of non-party Elektrim S.A. to breach a contract pursuant to which Elektrim S.A. would have purchased all of the shares of Pilicka Telefonía S.A. in August of 1999. Because a motion was granted to dismiss the claims that PenneCom had asserted pursuant to Polish and Dutch law, as well as a New York law fraud claim, the only claim currently being litigated is the tortious interference with contract claim asserted under New York law. The case is currently in discovery. No date has been set for trial. The outcome of the litigation cannot be determined and no amount has been recognized for possible collections of any claims. PenneCom will continue to incur legal costs in connection with this action.

We are involved in various legal proceedings arising in the ordinary course of our business. In the opinion of management, the ultimate resolution of these matters will not have a material adverse effect on our consolidated financial condition, results of operations or cash flows.

Item 4. *Submission of Matters to a Vote of Security Holders*

There were no matters submitted to a vote of the shareholders during the fourth quarter of 2005.

Table of Contents**PART II****Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Our common stock trades on The NASDAQ Stock Market under the symbol DECC. The table below sets forth the high and low bid prices of our common stock during each of the periods indicated, as reported daily by the NASDAQ National Market.

<u>2005</u>	<u>Low</u>	<u>High</u>
First Quarter	\$8.12	\$12.36
Second Quarter	\$7.00	\$10.10
Third Quarter	\$9.00	\$12.23
Fourth Quarter	\$7.80	\$ 9.41
<u>2004</u>	<u>Low</u>	<u>High</u>
First Quarter	\$13.41	\$15.48
Second Quarter	\$11.04	\$14.70
Third Quarter	\$ 9.83	\$13.39
Fourth Quarter	\$11.13	\$14.02

The bid quotations reflect inter-dealer quotations, do not include retail markups, markdowns, or commissions, and may not necessarily represent actual transactions. The bid information stated is, to our knowledge, the best approximate value at the time indicated.

The closing price on December 31, 2005, was \$8.33. Based on records that we maintain, the approximate number of record holders of our common stock, as of December 31, 2005, was 2,289.

During the two most recent fiscal years, 2005 and 2004, cash dividends on our common stock have been declared quarterly in the annual amount of \$0.50 per share. Dividends are paid as and when declared by our Board of Directors and in accordance with restrictions set forth in covenants contained in our debt agreements.

Equity Compensation Plan Information

<u>Plan Category</u>	<u>(A) Number of securities issued upon exercise of outstanding options, warrants and rights</u>	<u>(B) Weighted- average exercise price of outstanding options, warrants and rights</u>	<u>(C) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u>
Equity compensation plans approved by security holders	221,405	\$ 10.06	1,026,858
Equity compensation plans not approved by security holders	—		—
Total	<u>221,405</u>	\$ 10.06	<u>1,026,858</u>

Recent Sales of Unregistered Securities

None

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None

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Item 6. Selected Financial Data

The following table sets forth selected consolidated summary financial information as of December 31 and for each of the last five fiscal years ended December 31, 2005. This information should be read in conjunction with our consolidated financial statements, including the notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations, both of which are included in this annual report. Certain amounts have been reclassified for comparative purposes.

	At or for the Year Ended December 31,				
	2005 ⁽¹⁾	2004 ⁽¹⁾	2003 ⁽¹⁾	2002 ⁽¹⁾	2001
	(In thousands, except per share data)				
STATEMENT OF OPERATIONS DATA					
Operating revenues	\$176,247	\$176,271	\$173,125	\$ 137,334	\$ 76,055
Depreciation and amortization	38,745	39,119	38,626	28,690	15,289
Operating income (loss)	22,659	20,947	23,767	7,275	(530)
Income (loss) from continuing operations	13,711	(2,739)	3,877	(7,105)	1,810
Discontinued operations, net of tax ⁽²⁾	—	—	(53)	55,499	(5,969)
Extraordinary loss, net of tax	—	—	—	—	107
Cumulative effect of accounting change, net of tax	—	—	260	—	—
Net income (loss)	13,711	(2,739)	4,084	48,394	(4,052)
PER-SHARE DATA — BASIC AND DILUTED ⁽³⁾					
Income (loss) from continuing operations	\$ 0.96	\$ (0.18)	\$ 0.25	\$ (0.58)	\$ 0.25
Discontinued operations	—	—	—	4.53	(0.81)
Extraordinary items	—	—	—	—	0.01
Cumulative effect of accounting change	—	—	0.01	—	—
Net income (loss) per common share	0.96	(0.18)	0.26	3.95	(0.55)
Cash dividends declared per common share	0.50	0.50	0.50	0.50	0.50
BALANCE SHEET DATA					
Total assets	\$535,672	\$546,785	\$575,911	\$ 601,818	\$142,878
Long-term debt	205,500	218,500	222,765	244,966	58,124
Preferred stock of subsidiary	1,446	1,446	1,446	1,446	1,446
OTHER DATA					
Net cash provided by continuing operating activities	\$ 41,613	\$ 49,595	\$ 45,009	\$ 25,161	\$ 13,684
Net cash used in continuing investing activities	(20,344)	(25,736)	(9,512)	(177,579)	(36,256)
Net cash provided by (used in) continuing financing activities	(19,461)	(27,788)	(18,183)	88,997	26,904

(1) Reflects data for Conestoga operations since acquisition on May 24, 2002.

(2) Reflects the results of our interest in the PCS ONE joint venture and our paging businesses as discontinued operations.

(3) The per-share data is based upon the weighted average common shares outstanding. Computations of earnings for all years are in accordance with Statement of Financial Accounting Standards No. 128, "Earnings per Share."

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

Monetary amounts presented in the following discussion are in thousands, except per-share amounts.

Overview

This Overview is intended to provide a context for the following Management's Discussion and Analysis of Financial Condition and Results of Operations. Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our consolidated financial statements, including the notes thereto, included in this annual report. We have attempted to identify the most important matters on which our management focuses in evaluating our financial condition and operating performance and the short-term and long-term opportunities, challenges and risks (including material trends and uncertainties) which we face. We also discuss the actions we are taking to address these opportunities, challenges and risks. The Overview is not intended as a summary of, or a substitute for review of, Management's Discussion and Analysis of Financial Condition and Results of Operations. For comparative purposes, certain amounts have been reclassified to conform to the current-year presentation. The reclassifications had no impact on net income.

Business Segments

We operate as a rural local telephone company providing integrated communications services to residential and business customers in markets throughout the eastern half of Pennsylvania. We operate an incumbent rural local exchange carrier, or RLEC, in parts of Berks, Lancaster, Union and smaller portions of five other adjacent counties in Pennsylvania, and a competitive local exchange carrier, or CLEC, in the Lancaster, Harrisburg, Reading, Altoona, Pottstown, State College and Williamsport, Pennsylvania metropolitan areas, which we refer to as our "edge-out" markets. We offer our customers a comprehensive package of communications services including local and long distance telephone services, broadband services, Internet access and, in certain of our markets, video services. We also provide business customers with integrated voice and data network solutions.

Our segments are RLEC, CLEC, Internet Services, and Systems Integration. The measure of profitability that management uses to evaluate performance of our business segments is operating income (loss) because individual segments are not charged an allocation for such items as interest and income taxes that are reported below operating income on the statement of operations.

As of December 31, 2005, we served 134,698 RLEC access lines, 40,796 CLEC access lines, 19,795 digital subscriber lines ("DSL"), 7,959 dial-up Internet access subscribers, 6,630 video subscribers and 952 web-hosting customers. For the year ended December 31, 2005, we generated total revenues of \$176.2 million, operating income of \$22.7 million and net income of \$13.7 million.

Historically, we have derived a majority of our revenues and substantially all of our operating income from the regulated RLEC segment. Our RLEC revenue is derived primarily from local telephone service, network access charges, enhanced telephone services, directory and regional toll service. Our CLEC focuses primarily on businesses, and revenue is derived primarily from local telephone service, network access charges, enhanced telephone services and long distance service revenue. Our Internet Services revenue is derived from broadband and dial-up Internet access services, in addition to web-hosting services and our new Voice over Internet Protocol ("VoIP") service. Our Systems Integration revenue is derived from sales of services and equipment that support the design, implementation and maintenance of local and wide area networks and telecommunications systems.

Our operating costs and expenses primarily include wages and related employee benefit costs, depreciation and amortization, selling and advertising, software and information system services and general and administrative expenses. Our RLEC segment incurs costs related to network access charges, directory expense, and other operations expenses such as digital electronic switch expense, engineering and outside plant costs. Our CLEC incurs costs related to leased network facilities associated with providing local telephone service to

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customers, engineering costs, and network access costs for local calls and long distance expense. Our Internet Services segment incurs leased network facilities costs for our dial-up Internet service and for our DSL broadband service. Our Systems Integration business incurs expenses primarily related to wages and employee benefit costs, and equipment and materials used in the course of the installation and provision of our products and services.

We incur access line-related capital expenditures associated with access line additions, expenditures for upgrading existing facilities to provide broadband services and costs related to the provision of DSL Internet services in our RLEC and CLEC territories. Our capital expenditures related to CLEC access line growth are generally associated with serving additional customers or servicing existing customers on our own facilities and, therefore, tend to result in incremental revenue or higher margins from those customers. We believe that our additional capital expenditures relating to our investment in software and systems will allow us to remain competitive in the marketplace and generally allow for corresponding reductions in operating expenses.

Business Strategy

Our primary business objective is to be a leading, regional integrated communications service provider ("ICP"). To achieve this objective, we will continue to pursue the following goals:

- We will pursue the goal of capturing as many broadband connections to customers' homes and businesses as possible. While we intend to continue to serve our dial-up Internet access customer base, our focus will be to migrate these customers in the RLEC and CLEC areas to broadband connections. New broadband customers will also be aggressively pursued. Targeting customers with a broadband connection to their home and/or business is vital for the future delivery of Internet Protocol ("IP") services.
- We will continue to build-out our fiber-to-the-node infrastructure to support the future deployment of advanced broadband IP communication services. We expect that the demands of our residential and business customers for increased bandwidth and IP applications will continue to grow.
- We will continue to operate under a disciplined strategy to increase our market share in our edge-out markets, primarily to business customers, by offering competitive communication service packages. We will continue to leverage our modern network infrastructure, established reputation, extensive local knowledge and significant operating experience to attempt to gain new customers and increase our market share in our edge-out markets. Our focus will be on acquiring customers that can be served from our own network facilities and moving existing customers from leased facilities to our own network.
- We will pursue the goal of delivering excellence for our customers by providing reliable, responsive, state of the art broadband communications services, including voice, high-speed data, VoIP and, in certain of our RLEC and CLEC markets, video. We will assess and tailor the bundling of services to best serve our customers and endeavor to achieve a competitive advantage in our local markets. We have direct experience with video deployments on two technology platforms – hybrid fiber coaxial in the State College CLEC market and ADSL2 over the RLEC copper system in Union County, Pennsylvania. The potential roll-out of video in our other RLECs is under review and evaluation.
- We will endeavor to be a single source provider of voice and data communications services to our business customers. We believe that the convergence and complexity of voice communications and data network technologies has increased the need for businesses to seek a single provider for all of their communications and data networking needs. In 2006, we will be creating a more direct link between our RLEC, CLEC and Internet customer base and the Systems Integration business through joint sales proposals, sales incentive plans, and needs-based proposals that combine Systems Integration and RLEC, CLEC or Internet services for a custom and differentiated offering.
- We will continue to make our commitment to customer service a top priority. Our NOC provides monitoring, repair and emergency services 24 hours a day, 7 days a week and 365 days a year, which

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strengthens our relationships with our customers and enhances our competitive position. In an effort to speed up and enhance the customers' experience when they call in service issues, we implemented a new case management system into the NOC. The system has given us the ability to better manage and prioritize service calls resulting in greater ability to manage the customer's request. To further enable this, several automated tests were developed and implemented that allow us to analyze every issue that is called in, and within 2 minutes, determine the location of the issue and identify and dispatch the appropriate technician. Our complement of managed services is used for internal monitoring (within the customer's enterprise), external monitoring (devices visible outside the customer's enterprise) and comprehensive security assessments and management. Our managed services fills the needs of our customers by allowing them to improve reliability, provide higher levels of service and save money through efficient device management and planning.

- We will offer a broad array of advanced communication services that will enable new modes of communication to become a part of the daily home or business experience. A unified communications strategy will provide integrated applications (e.g. email, voice mail, instant messaging and video conferencing) to provide customers with greater flexibility to select their preferred method of communication.

Critical Developments in the Communications Industry

One of the critical drivers in the communications industry today is the convergence of voice and data communication technologies into various IP based platforms, all of which have the potential to provide VoIP, broadband services, and IP video over telephone companies' copper and fiber networks, cable companies' coaxial and fiber networks, wireless telephone companies' wireless networks, satellite companies' satellite networks and electric companies' electric lines. Although each of the networks has relative strengths and weaknesses, they are all effectively in competition for the customers' communications needs. These developments mean that we are competing for our existing customer base in our RLEC and CLEC territories with cable TV companies, wireless telephone companies, satellite communications providers and VoIP providers. The recent decreases in the number of access lines in our RLEC territories reflect, in part, such increased competition, in addition to the elimination of lines by our customers as they shift to DSL for high-speed Internet access.

We have competitive strengths and weaknesses in the competition for the customer's communications dollar. On a national basis, cable TV companies have the major market share of paid video services and have a larger market share of broadband Internet access services, than telephone companies. Cable TV companies are now delivering VoIP services with systems fully capable of providing IP telephony services. We are now offering video over a portion of our fiber-copper network in the area of Lewisburg, Pennsylvania in competition with the video services offered by incumbent cable companies.

Cable TV companies are typically subject to far less regulation in the provision of voice telephone services than are local telephone companies. There is limited regulation of VoIP offerings at this time, placing VoIP at a possible regulatory advantage over traditional telephone services. To date, VoIP is not regulated as a voice public utility service, except to the extent that the Federal Communications Commission ("FCC") has recently ordered that VoIP providers must enable their customers to access 911 services. To maintain and grow our voice communication business, we are introducing VoIP offerings into our marketplace. The convergence of voice and data networks enables the deployment of VoIP services. As an Internet Service Provider ("ISP"), our provision of VoIP services is not geographically limited. We have the potential to offer and provide our VoIP services anywhere to anyone who has a broadband connection, either through a DSL or cable modem connection. The deployment of VoIP services minimizes the amount of additional infrastructure costs required to offer next generation voice services outside of our traditional service territories. Our VoIP initiatives may drive converged services and networks to produce operational efficiencies in addition to benefiting from the current minimal regulation to which it is subject. Other VoIP providers can offer VoIP services within our territory from any point outside of our territory that has Internet access, subject to the requirement of also providing 911 service. If

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they qualify as a CLEC in our RLEC territories, VoIP providers also might be eligible for number portability. Number portability would make it possible for our customers to switch to the VoIP services of another provider without changing telephone numbers.

The delivery systems of local telephone companies and cable TV companies are structured differently. Telephone systems are structured to foster two-way conversations by providing separate lines to each customer. This structure enables telephone systems, as they are upgraded to provide DSL and even video services, to transmit with similar capacities to and from customers' premises without the system slowing down or failing in times of high traffic. Cable TV systems were originally structured to carry traffic one way to the customer and, although the systems are being upgraded to carry two-way traffic, cable TV systems are not structured as well as telephone systems to carry two-way traffic with the result that, in times of peak demand, cable TV systems may slow down or even fail to transmit their cable Internet traffic. This fundamental difference in the structure of telephone and cable systems can give telephone companies an advantage in providing DSL and IPTV services, as both are highly interactive systems requiring fast transmittals in both directions. According to widely published sources of business information, nationally, the growth rate of DSL subscribers has recently been outpacing the growth rate of cable modem subscribers, although cable is still ahead in terms of total subscribers. We have been quite successful in marketing our DSL Internet service to new subscribers, with the number of subscribers increasing from 11,015 as of December 31, 2004 to 19,795 as of December 31, 2005, a 79.7% increase. During the same period, the number of our RLEC access lines decreased by 3.5% from 139,607 as of December 31, 2004 to 134,698 as of December 31, 2005.

We are also in competition with providers of wireless telephone and data services for the local telephone and data customer. Wireless telephone service providers have impacted our number of RLEC access lines as customers use wireless for a second line and even substitute wireless entirely for wireline service. We believe that wireline telephone and broadband transmissions still have significant advantages over wireless services in terms of rapid data rates and service accessibility and reliability. Our broadband emphasis through the expansion of our fiber-to-the-node deployment, prepares us for accommodating the continuing demands of increased bandwidth for both consumers and businesses. However, the access and mobility provided by wireless technologies creates tremendous value as the communications industry seeks to provide a seamless integration between wireline and wireless networks. We are evaluating the capacity to provide local wireless data services, through Wi-Fi, WiMax and 700Mhz technologies, in order to provide full broadband coverage to our customers.

The competitive threat posed by the convergence of technologies makes our commitment to customer service even more critical to the protection of our competitive position. We are a local company with local connections that can give individual, personalized service. We are also small enough to be able to provide an individual response to customer services needs. We feel that this responsiveness will be critical to our ability to successfully convince both our business and residential customers to see us as their "preferred provider" of integrated communications services, particularly in light of the substantially greater resources of many of our competitors.

In order to remain competitive and provide the broadband services required for high-speed data and video, we must continue to invest substantial amounts in our infrastructure. We have installed significant amounts of fiber in our system. We have even been installing ducts into new houses and businesses over the last 10 years to enhance our ability to install fiber. We have installed "gigabit" networks, and believe that we have the expertise to lead the way to providing ubiquitous broadband access in our markets. We have completed 98% of our requirements under Act 183 of the Pennsylvania Public Utility Code to provide broadband availability in 100% of our RLEC system by December 31, 2008. In keeping with the foregoing, our 2006 capital budget is approximately \$26 million. However, as discussed more fully under the Business Risks section, our ability to invest in infrastructure to remain competitive may be limited by our indebtedness of approximately \$215.5 million as of December 31, 2005.

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Business Risks

Our primary business risks include the external threats of increased competition, the complex and uncertain regulatory environment in the telecommunications industry and the internal risk of our debt financing.

- Risk of increased competition

As described under the heading Critical Developments in the Communications Industry, the convergence of voice and data communication technologies has brought telephone companies into direct competition with cable TV companies, wireless telephone companies, VoIP providers and satellite companies. The development of VoIP has enabled cable TV companies to provide telephone service in competition with us. These developments have placed our core telephone business at risk, although also enabling us to compete in the provision of cable TV services.

It is basic policy of the FCC and the Pennsylvania Public Utility Commission ("PUC") to encourage competition in the communications industry. The limited suspension that we held until January 2003 from certain interconnection requirements of the Telecommunications Act of 1996 has been discontinued, although legislation enacted in Pennsylvania in the fourth quarter of 2004 provided a continued limited suspension to our Buffalo Valley RLEC through December 31, 2008. These developments mean that two of our RLECs could be required to allow competitors to have access to our customers by our competitors seeking the removal of our rural exemption, entering our territory and using our facilities through interconnection agreements to provide local services. Local cable TV companies may use their own facilities and apply to be licensed as a facilities-based CLEC within our franchise territory in order to attempt to qualify for number portability. This would enable our existing telephone customers to switch to VoIP services provided by the cable TV companies and still retain the same telephone numbers, thus making the transfer of local telephone services to VoIP far more convenient to the customer. Service Electric Telephone Company, LLC, filed on September 2, 2005 with the PUC to be a facilities-based CLEC competitor in our Conestoga RLEC territory. In addition, CORE Communications, Inc. ("CORE") filed an amended application on August 19, 2005 with the PUC to be a facilities-based CLEC providing service in our RLEC territories. On January 25, 2006, CORE served our three RLECs with their Petition for Arbitration. Included in Appendix 2 of their filing is a request seeking a termination of the rural exemption for the limited purpose of permitting the interconnection standards to apply to any direct interconnection between our three RLECs and CORE. We are actively engaged in these filings and will be working with both CLECs to develop interconnection agreements to be filed with the PUC.

In areas served by our CLEC, the incumbent carrier, Verizon, enjoys certain business advantages, including its size, financial resources, brand recognition and network connection to virtually all of our customers and potential customers in those areas. Similarly, in areas where we do or may provide video services, the incumbent cable operators enjoy certain business advantages, including their size, financial resources, brand recognition, and ownership of or superior access to programming.

- We are subject to a complex and uncertain regulatory environment that may require us to alter our business plans and face increased competition.

The United States communications industry is subject to federal, state and local regulations that are continually evolving. As new communications laws and regulations are issued, we may be required to modify our business plans or operations, and we may not be able to do so in a cost-effective manner. Federal and state regulatory trends toward a more competitive marketplace through reduced competitive entry standards are likely to have negative effects on our business and our ability to compete. In this regard, the regulatory environment governing incumbent local exchange carrier ("ILEC") operations has been and will likely continue to be very liberal in its approach to promoting competition and network access, which may increase the likelihood of new competitors offering similar services in our service areas. The introduction of new competitors could have a negative effect on our RLEC operating results yet at the same time present operating benefits to our CLEC business.

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Prices for RLEC's interstate services, consisting primarily of subscriber line charges and access charges for interstate and international toll calls, are regulated by the FCC based on the "average schedule" formulas proposed by National Exchange Carrier Association ("NECA"). Removal of the RLECs from the NECA average schedule formulas could result in a significant revenue loss. Changes in the average schedule formula amounts developed by NECA and implemented annually in July could have a negative effect on the RLEC's future revenues. NECA filed their annual updated formulas with the FCC to be effective July 1, 2006. This update proposes major reductions to settlements received by larger RLECs, including our three RLECs. It also proposed a two-year transition for implementing the new calculations. Based on our evaluation we estimate the impact, excluding any transition period, would be approximately a \$1 million reduction in 2006 network access revenues for the six-month period beginning July 1, 2006, or an annual decrease of \$2 million. It is estimated that approval of the proposed transition plan to phase in new settlement calculations over a longer period could reduce the 2006 impact by as much as 50% to 75%. The FCC has requested comment from interested parties on NECA's filing. We will not know until June 2006 whether the FCC accepts the revised calculations of NECA or whether the FCC will accept the two-year transition of the reduced settlement amounts.

The PUC is currently considering changes in intrastate switched access rates and Universal Service Funding ("USF") reform for independent local exchange carriers in Pennsylvania. The proceeding, which began in December 2004, addresses the rates that our RLECs charge to long distance carriers for intrastate toll calls that originate or terminate on our RLECs' local telephone lines. Our RLECs also receive funding from the Pennsylvania USF, which could be affected by the PUC's investigation. At this time, we cannot predict either the timing or the outcome of the PUC's proceeding.

On February 10, 2005, the FCC initiated a proceeding to develop a unified intercarrier compensation regime. This proceeding will likely affect our RLECs, CLECs, long distance and VoIP operations. The FCC is considering various plans that have been submitted to the FCC and has solicited comments from the public concerning those proposals. Most, if not all of these proposals, if adopted, would affect the intercarrier compensation revenues and expenses as well as the USF funding that our RLECs receive. The rule changes that result from this proceeding could have a material effect on our revenues, expenses and earnings. Until the FCC adopts a specific proposal, it is impossible to predict how changes will affect our company.

- Risk of debt financing

We had indebtedness of approximately \$215.5 million at December 31, 2005. We refinanced our indebtedness in March 2004 and further amended our credit facility in November 2004. The effect of the refinancing was to lower the interest rates on our indebtedness, provide greater flexibility in our financial covenants and spread out the amortization of principal. The refinancing also lifted restrictions on the expansion of our CLEC edge-out market and eliminated the requirement of the prior loan agreement that excess cash flow be applied to prepayments of principal. This new structure, pursued to manage our balance sheet in order to better achieve our business plan, decreases the risks associated with our indebtedness. However, our indebtedness could still restrict our operations because:

- We will use a substantial portion of our cash flow from operations to pay principal and interest on our indebtedness, which will reduce the funds available for working capital, capital expenditures, acquisitions and other general corporate purposes.
- Certain covenants in our loan agreement limit the amount of capital investment.
- The level of indebtedness will make us more vulnerable to economic or industry downturns, and our debt service obligations increase our vulnerability to competitive pressures, as we may be more leveraged than many of our competitors.

The foregoing opportunities and risks require management to attempt to balance several aspects of our business. Our RLEC business segment provides cash flow both to pursue our business plan to be a leading,

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regional broadband ICP and to provide a current return on investment to our shareholders in the form of a dividend. However, because our resources are limited, and the manner in which the communications industry will develop is uncertain, both in terms of technology and competition, we may not be able to pursue every possible avenue of development, and critical decisions will need to be made at various stages of our evolution as a company. These decisions can be made more difficult by our desire to balance our short-term goals of maintaining our RLEC business segment and dividend return and our long-term goal of providing voice, data and video services on the next generation, IP-based network. Maintaining our dividend payout may be challenging due to the capital requirements of our business strategy, payments of principal and interest on our long-term debt and restrictions under our financing facilities, both in the form of an annual limitation of \$10 million in dividends and the requirement to remain in compliance with financial covenants.

Results of Operations

The measure of segment results used by management is operating income (loss). Certain amounts from prior years have been reclassified to conform to the current presentation. The following table is a summary of our operating results by segment:

	RLEC	CLEC	Internet Services	Systems Integration	Corporate & Other	Eliminations	Total Company
2005							
Revenues — External	\$100,934	\$38,291	\$12,999	\$ 20,241	\$ 3,782	\$ —	\$176,247
Revenues — Intercompany	9,517	2,505	40	28	—	(12,090)	—
Total Revenues	110,451	40,796	13,039	20,269	3,782	(12,090)	176,247
Depreciation and Amortization	29,524	5,052	1,378	1,624	1,167	—	38,745
Other Operating Expenses	48,395	37,255	12,303	24,435	4,545	(12,090)	114,843
Total Operating Expenses	77,919	42,307	13,681	26,059	5,712	(12,090)	153,588
Operating Income (Loss)	\$ 32,532	\$ (1,511)	\$ (642)	\$ (5,790)	\$ (1,930)	\$ —	\$ 22,659
2004							
Revenues — External	\$101,647	\$36,183	\$10,337	\$ 24,771	\$ 3,333	\$ —	\$176,271
Revenues — Intercompany	9,314	1,409	21	54	—	(10,798)	—
Total Revenues	110,961	37,592	10,358	24,825	3,333	(10,798)	176,271
Depreciation and Amortization	30,776	4,394	1,083	1,899	967	—	39,119
Other Operating Expenses	51,023	35,893	8,948	27,506	3,633	(10,798)	116,205
Total Operating Expenses	81,799	40,287	10,031	29,405	4,600	(10,798)	155,324
Operating Income (Loss)	\$ 29,162	\$ (2,695)	\$ 327	\$ (4,580)	\$ (1,267)	\$ —	\$ 20,947
2003							
Revenues — External	\$105,087	\$34,830	\$ 6,862	\$ 23,378	\$ 2,968	\$ —	\$173,125
Revenues — Intercompany	8,207	923	479	31	22	(9,662)	—
Total Revenues	113,294	35,753	7,341	23,409	2,990	(9,662)	173,125
Depreciation and Amortization	31,591	4,036	794	1,734	471	—	38,626
Other Operating Expenses	48,040	35,554	6,656	25,997	4,147	(9,662)	110,732
Total Operating Expenses	79,631	39,590	7,450	27,731	4,618	(9,662)	149,358
Operating Income (Loss)	\$ 33,663	\$ (3,837)	\$ (109)	\$ (4,322)	\$ (1,628)	\$ —	\$ 23,767

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Consolidated Operations

Overview of 2005 Compared to 2004

Consolidated operating revenues from continuing operations in 2005 decreased \$24, to \$176,247, from \$176,271 in 2004. The decrease included \$3,464 of lower professional services revenues partially attributable to the expiration of a major computer services contract, a \$1,687 decline in long distance revenues primarily attributable to a reduction in the average rate per minute of use and a computer equipment sales decrease of \$740. These decreases were offset by increases of \$1,225 in local telephone service primarily from additional CLEC business customers, \$1,944 of DSL revenue attributable to additional customers, \$1,331 of network access revenue primarily from increased NECA settlements and \$647 of directory revenue.

Consolidated operating income from continuing operations in 2005 increased \$1,712, to \$22,659, from \$20,947 in 2004. The increase was primarily attributable to reductions in operating expenses. Expense decreases included \$1,933 from lower wages and subcontractors' costs, \$430 of network access expense partially related to a lower cost contract for completing long distance calls, \$1,303 of contracted billing service expenses and \$800 of computer equipment sale costs. Offsetting increases included \$1,793 in benefits primarily from pension expense and \$1,011 of operating taxes primarily as a result of a one-time sales tax refund received in 2004.

Net income (loss) increased \$16,450, to net income of \$13,711 in 2005 from a net loss of \$2,739 in 2004, partially due to the increase in operating income described in the preceding paragraph, net of income taxes. Other factors related to the increase include the equity in net income (loss) of affiliates increase of \$4,172, to income of \$1,000 in 2005 compared to a loss of \$3,172 in 2004, gain (loss) on investments increased \$7,952, to a gain of \$6,895 in 2005 compared to a loss of \$1,057 in 2004, due to gains on the sale of our interests in Pilicka and PenTeleData in 2005 and the loss on early extinguishment of debt of \$5,252 related to the debt refinancing in March 2004 and the amendment in November 2004.

Overview of 2004 Compared to 2003

Consolidated operating revenues from continuing operations increased \$3,146, or 1.8%, to \$176,271 in 2004 from \$173,125 in 2003. The revenue increase was primarily due to the growth in DSL Internet Services and an increased number of CLEC customers during 2004. Changes in how we are compensated by certain wireless carriers to use our RLEC network have reduced revenues by a net of \$1,300 in spite of an increase in total switched cellular minutes. The Corporate and Other revenues change included an increase for video operations and a decrease in revenues due to the sale of Conestoga Wireless in January 2003, which resulted in decreased revenue of \$456.

Consolidated operating income from continuing operations for 2004 decreased \$2,820, to \$20,947 in 2004 from \$23,767 in 2003. The decreased operating income in 2004 was partially attributable to approximately \$900 of increased employee medical benefit expenses, approximately \$900 for compliance with Sarbanes-Oxley regulations and over \$400 of increased operating losses associated with video services since its expansion into the Buffalo Valley market in mid 2003.

Net income (loss) decreased \$6,823, to a loss of \$2,739 in 2004 from an income of \$4,084 in 2003, partially due to the decrease in operating income discussed above, net of income taxes. Other factors related to the decline were the loss on early extinguishment of debt of \$5,252 related to the debt refinancing in March 2004 and the amendment in November 2004, which was only partially offset by an interest expense reduction of \$3,685. In 2004, the equity in loss of affiliates included \$2,125 for our share of an impairment of assets at Pilicka and an impairment of our investment in EuroTel. Also, in 2003, there was a \$790 realized gain on the disposition of investments available-for-sale.

Table of Contents**RLEC Segment Results****Summary Operating Results — RLEC Segment**

	2005	2004	2003
Revenues:			
Local Telephone Service	\$ 33,246	\$ 33,607	\$ 33,428
Network Access	55,293	54,915	57,017
Directory	15,923	15,335	13,201
Other	5,989	7,104	9,648
Total Revenues	<u>110,451</u>	<u>110,961</u>	<u>113,294</u>
Depreciation and Amortization	29,524	30,776	31,591
Other Operating Expenses	48,395	51,023	48,040
Total Operating Expenses	<u>77,919</u>	<u>81,799</u>	<u>79,631</u>
Operating Income	<u>\$ 32,532</u>	<u>\$ 29,162</u>	<u>\$ 33,663</u>
Operating Income % of Revenues	29.5%	26.3%	29.7%
Access Lines at December 31	134,698	139,607	142,799

RLEC segment revenues decreased \$510, or 0.5%, to \$110,451 in 2005 and decreased \$2,333, or 2.1%, to \$110,961 in 2004. In 2005, basic area telephone service decreased \$237 due to the net effect of a decrease in access lines, offset by an increase in basic service fees effective August 1, 2005 that resulted in additional revenue of approximately \$700. Network access revenue increased \$378, primarily from the net effect of increased NECA settlements of \$2,333 partially related to rate changes in the NECA average schedule settlement formulas effective in July 2005, additional inter-segment DSL revenue of \$1,055 due to an increase in the number of customers, decreases of approximately \$1,753 from fewer special access circuits, a decline in switched access revenues of \$354 and a reduction in interstate access revenues of \$681 due to decreases in minutes of use and rates. Long distance revenues decreased \$434 and revenue from inter-segment billing and collection services was down \$963. Since November 2004, expenses for preparation of customer billing are charged directly to each segment. Prior to the November 2004 billing conversion, certain expenses were recorded in one segment and then recorded as inter-segment billing and collection revenue.

In 2004, local telephone service revenues increased and network access revenues decreased by similar amounts as part of a rate rebalancing in July 2003. Dedicated data circuits and leased facilities grew in 2004, increasing both local telephone service and network access revenues. Access revenues decreased due to the net effect of a revision to our NECA settlements estimate, increased wireless minutes of use resulting in approximately \$450 additional revenue, and a new reciprocal compensation agreement with a wireless carrier which decreased revenue approximately \$1,750. Other revenue decreased as a result of reductions in long distance revenues and premise hardware and services revenues more than offsetting the increase in directory revenue.

RLEC segment operating expenses decreased \$3,880, or 4.7% to \$77,919 in 2005 and increased \$2,168, or 2.7%, to \$81,799 in 2004. In 2005, decreases included \$1,007 for contracted billing services, \$1,252 in depreciation due to changes in the estimated lives of various fixed asset categories, \$454 in network access expenses, \$633 in maintenance contracts and \$1,151 in corporate overhead expenses as a result of our other business segments receiving a larger share of the allocation of corporate overhead expenses, which are allocated to each segment based on the average of segment revenues, expenses and certain balance sheet amounts. These decreases more than offset a \$733 increase in the cost of employee benefits. In 2004, directory expense increased in line with directory revenues. Operating expenses increased due to the cost of complying with the provisions of the Sarbanes-Oxley Act relating to internal controls over financial reporting which was primarily allocated to the RLEC segment. Operating income increased \$3,370, or 11.6%, in 2005 to \$32,532 and decreased \$4,501, or 13.4%, in 2004 to \$29,162.

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Local telephone revenues are anticipated to continue to decline as the result of continuing access line losses due to increasing competition from wireless and cable providers offering alternative services, including VoIP. Network access revenues are projected to decrease due to declining minutes of use and less favorable NECA settlements for average schedule companies. NECA filed their annual updated formulas with the FCC to be effective July 1, 2006. This update proposes major reductions to settlements received by larger RLECs, including our three RLECs. It also proposed a two-year transition for implementing the new calculations. Based on our evaluation we estimate the impact, excluding any transition period, would be approximately a \$1,000 reduction in 2006 network access revenues for the six-month period beginning July 1, 2006, or an annual decrease of \$2,000. It is estimated that approval of the proposed transition plan to phase in new settlement calculations over a longer period could reduce the 2006 impact by as much as 50% to 75%. The FCC has requested comment from interested parties on NECA's filing. We will not know until June 2006 whether the FCC accepts the revised calculations of NECA or whether the FCC will accept the two-year transition of the reduced settlement amounts. Other revenues, which include enhanced services (voice mail, custom calling features) and other miscellaneous services, are likely to continue the trend of moderate increases. At the same time, we expect continued decreases in long distance service revenues.

CLEC Segment Results

Summary Operating Results — CLEC Segment

	2005	2004	2003
Revenues:			
Local Telephone Service	\$13,422	\$11,607	\$ 9,762
Network Access	9,836	6,684	5,607
Long Distance	16,927	18,285	19,570
Other	611	1,016	814
Total Revenues	40,796	37,592	35,753
Depreciation and Amortization	5,052	4,394	4,036
Other Operating Expenses	37,255	35,893	35,554
Total Operating Expenses	42,307	40,287	39,590
Operating Loss	<u>\$ (1,511)</u>	<u>\$ (2,695)</u>	<u>\$ (3,837)</u>
Operating Loss % of Revenues	(3.7)%	(7.2)%	(10.7)%
Access Lines at December 31	40,796	38,461	35,140

CLEC segment revenues increased \$3,204, or 8.5%, to \$40,796 in 2005 and \$1,839, or 5.1%, to \$37,592 in 2004. The 2005 increase was related to the 6.1% increase in access lines and growth in the number of dedicated data circuits, which increased local telephone service and network access revenues approximately \$3,521. State access revenue increased \$936 from higher minutes of use. Long distance revenues decreased approximately \$1,358 due to a decline in the average rate per minute of use and the loss of one significant customer. The 2004 increase was related to the addition of access lines for new customers and growth in dedicated data circuits, which increased both local telephone service and network access revenues. These increases were offset by a \$1,285 decrease in long distance revenues due to rate reductions and decreased minutes of use.

CLEC segment operating expenses increased \$2,020, or 5.0%, to \$42,307 in 2005 and \$697, or 1.8% to \$40,287 in 2004. In 2005, wages increased \$144 and benefits increased \$453 as a result of our need to support a larger customer base and increased pension costs. Depreciation increased \$658 from asset additions and decreases in estimated lives of certain assets. The cost of services increased \$2,016 related to providing more leased facilities required by customer growth. Network access expenses decreased \$1,843 as a result of savings achieved from the implementation of a new agreement to provide a least-cost routing service for completion of long distance calls and partially from the loss of one significant customer. Customer billing expenses decreased

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\$165 resulting from completion of the billing conversion during the fourth quarter of 2004. Gross receipts taxes increased approximately \$284 due to a true up of the prior year tax return. Corporate overhead expenses, which are allocated to each segment based on the average of segment revenues, expenses and certain balance sheet amounts, increased \$919 as a result of a higher allocation than in the prior year. The increase in 2004 was primarily related to increases in the cost of leased facilities, wages and benefits, and depreciation, offset by a decrease in long distance costs and a reduction in subscriber billing costs. Operating losses decreased \$1,184, or 43.9%, to \$1,511 in 2005 and \$1,142, or 29.8%, in 2004 to \$2,695 primarily due to changes in operating efficiencies and moving more customers to our own network.

Local telephone service revenues are projected to grow moderately as additional access lines are placed in service in existing markets. Our strategy to place more lines, both new and existing, on our own network is expected to increase the operating margin of those lines by eliminating the need for leasing facilities from other local exchange carriers to provide service for those lines. Long distance revenues are expected to decrease due to increased competition and tighter margins, as competitors such as wireless carriers and VoIP providers continue to offer unlimited minute pricing.

Internet Services Segment Results

Summary Operating Results — Internet Services Segment

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Revenues	\$13,039	\$10,358	\$ 7,341
Depreciation and Amortization	1,378	1,083	794
Other Operating Expenses	<u>12,303</u>	<u>8,948</u>	<u>6,656</u>
Total Operating Expenses	<u>13,681</u>	<u>10,031</u>	<u>7,450</u>
Operating Income (Loss)	<u>\$ (642)</u>	<u>\$ 327</u>	<u>\$ (109)</u>
Operating Income (Loss) % of Revenues	(4.9)%	3.2%	(1.5)%
Customers at December 31			
DSL	19,795	11,015	7,127
Dial-up Access	7,959	11,535	12,859
Web-hosting Services	952	909	814

Internet Services segment revenues increased \$2,681, or 25.9%, to \$13,039 in 2005 and increased \$3,017, or 41.1%, to \$10,358 in 2004. The 2005 increase resulted from additional DSL customers and included approximately \$654 of DSL revenue recorded as CLEC revenue in the previous year, prior to the wholesale arrangement effective January 1, 2005. Revenue per DSL customer declined as a result of temporary promotional rates for new customers and the introduction of lower priced levels of DSL service. The decrease in the number of dial-up subscribers resulted in a 21.9% decrease in dial-up revenue. The revenue increase in 2004 resulted from a 54.6% increase in DSL customers, partially offset by a decrease of 10.3% in the number of dial-up Internet customers, some of whom switched to DSL.

Internet Services segment operating expenses increased \$3,650, or 36.4%, to \$13,681 in 2005 and \$2,581, or 34.6% to \$10,031 in 2004. In 2005, wages and benefits increased \$451 resulting from \$262 of additional costs for supporting a larger number of subscribers and \$189 related to the initiation of our new VoIP phone service. Other expenses incurred to initiate VoIP service totaled approximately \$304. The cost of services increased \$1,826 as a result of increased customers and a broadband capacity upgrade implemented to accommodate expected continued DSL subscriber growth. Depreciation increased \$295 as a result of more assets being employed and corporate overhead expenses also increased \$295 as a result of a higher percentage allocation of corporate overhead expense than in the prior year. In 2004, direct cost of operations and increased depreciation made up most of the increased costs. Labor and benefits, to a large extent for expanded customer services,

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accounted for over 40% of the increased costs. The 2005 operating loss was \$642 compared to an operating income of \$327 in 2004. The decrease in operating income in 2005 resulted primarily from the initiation of VoIP service, a higher percentage allocation of corporate overhead expenses and a decrease in the revenue per DSL customer.

Growth in providing broadband services is projected to increase in the next several years, as customer demand for greater speed and bandwidth continues. We expect continued growth in DSL customers, while the demand for dial-up access is decreasing rapidly. A consumer VoIP product was recently introduced with unlimited long distance at a competitively priced flat monthly fee. Although continuing investments must be made for equipment and infrastructure, we expect this segment to show positive operating income in the near future.

Systems Integration Segment Results

Summary Operating Results — Systems Integration Segment

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Revenues	\$20,269	\$24,825	\$23,409
Depreciation and Amortization	1,624	1,899	1,734
Other Operating Expenses	24,435	27,506	25,997
Total Operating Expenses	26,059	29,405	27,731
Operating Loss	<u>\$ (5,790)</u>	<u>\$ (4,580)</u>	<u>\$ (4,322)</u>
Operating Loss % of Revenues	(28.6)%	(18.4)%	(18.5)%

Systems Integration segment revenues decreased \$4,556, or 18.4%, to \$20,269 in 2005 and increased \$1,416, or 6.0%, to 24,825 in 2004. The 2005 decrease consisted of \$3,512 in communication services revenue related to a reduction in project hours worked for several large customers, certain price reductions and the expiration, on June 30, 2005, of a large government service contract. A decrease of \$1,044 in equipment sales resulted from \$282 lower voice equipment and \$762 lower computer equipment sales. In 2004, communication services increased \$706, made up of computer services of \$1,243 and equipment rentals of \$567 offset by decreases in repairs of \$1,104. Products sold increased \$710, primarily in telephone systems and cabling with minor increases in computer hardware sales. We believe these decreases partially related to the effects of increased competition and reductions in customer spending for communications related infrastructure and consulting services.

Operating expenses decreased \$3,346, or 11.4%, to \$26,059 in 2005 and increased \$1,674, or 6.0%, to \$29,405 in 2004. In 2005, wages, benefits and subcontractor services decreased \$2,083, material costs decreased \$812 related to the decline in revenue, depreciation decreased \$134 primarily due to certain fixed assets becoming fully depreciated in 2004 and amortization decreased \$141 due to certain intangible assets becoming fully amortized. In 2004, labor and benefits accounted for more than 80% of the expense increase. Operating losses increased \$1,210, to \$5,790, in 2005 and \$258, to \$4,580, in 2004.

In the Systems Integration segment there will be a continued focus on the promotion and sale of managed services and professional services, which are both expected to generate recurring revenue. In addition, sales of VoIP-based telephone systems are expected to produce higher margins than traditional telephone equipment. We have signed an agreement to partner with another vendor that will enable us to perform services for a major customer whose contract with us expired in 2005. Further, major expense reductions are being implemented to reduce the losses experienced in recent years, including reductions in labor costs by reducing the number of employees and reductions in rent expense by moving into smaller and less expensive office space beginning in April 2006.

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Other Income (Expense)

Other income (expense) for 2005 was an expense of \$3,077 compared to an expense of \$22,191 in 2004. The primary reasons for this \$19,114 change are as follows:

- Our equity in net income (losses) of affiliates increased \$4,172, to an income of \$1,000, in 2005 compared to a loss of \$3,172 in 2004. Our 2005 equity in net income of EuroTel included our share of EuroTel's gain on the sale of its direct ownership interest in Pilicka (see Note 5) in the amount of \$1,563 offset by EuroTel's operating expenses in 2005. We did not recognize any equity in losses of Pilicka in 2005 since we wrote our investment in Pilicka to zero at December 31, 2004 and had no legal obligation nor intention to provide future funding to Pilicka. The loss in 2004 included \$1,068 for our share of an impairment of assets in Pilicka. We have committed to fund EuroTel, on an equal basis with the other investors in EuroTel, certain of its operating cash needs and will continue to recognize our equity share of their ongoing losses.
- We recorded gains on investments in 2005 of \$6,895 compared to a loss on investment in 2004 of \$1,057. We sold our interest in PenTeleData in March 2005 resulting in a gain of \$2,043. In December 2005, we sold our direct ownership interest in Pilicka resulting in a gain of \$4,852. In 2004, we recognized an other-than-temporary loss of \$1,057 on our investment in EuroTel.
- In 2004, we incurred a loss on early extinguishment of debt of \$5,252 in regard to refinancing and amending our credit facility. There was no similar expense in 2005.
- Other, net was income of \$3,205 in 2005, compared to income of \$1,679 in the same period of 2004, partially from an increase of \$191 in the patronage dividend received as a borrower from a cooperative bank. Other, net also included \$2,073 of interest income and principal repayments collected in 2005 on the note received from the sale of assets of Conestoga Wireless compared to \$776 of interest income and principal repayments received in 2004. We recognize income upon collection of the note principal and interest as this note receivable is from a highly leveraged entity and the business sold had not generated positive cash flows prior to its sale. Therefore, the note receivable has not been recognized as an asset on our balance sheet.

Other income (expense) for 2004 was an expense of \$22,191 compared to an expense of \$17,857 in 2003. The primary reasons for this \$4,334 change are as follows:

- Our equity in net loss of affiliates increased to a loss of \$3,172 in 2004 from \$2,537 in 2003. The increased loss resulted from \$1,068 for our share of an impairment of assets in Pilicka offset by improved results of Pilicka's telephone operations and lower EuroTel legal expenses. Since we and EuroTel have no legal obligation nor intention to provide future funding to Pilicka, we each have written our investment in Pilicka to zero and discontinued recognizing our equity share of Pilicka's ongoing losses. EuroTel no longer records any value to its investment in Pilicka and therefore the value of our investment in EuroTel was written down as an other-than-temporary loss on investments of \$1,057. We have also committed to fund EuroTel on an equal basis with the other investors in EuroTel, certain of its operating cash needs and will continue to recognize our equity share of their ongoing losses.
- Our interest expense decreased \$3,685 in 2004, to \$14,389, primarily as a result of refinancing our syndicated senior secured credit facilities in March 2004 and amending the pricing of the Term Loan B in November 2004 as well as the beginning of scheduled principal repayments during 2004.
- In 2003, we recognized a gain of \$790 related to the sale of available-for-sale investments for which there was no similar gain in 2004.
- In 2004, we incurred a loss on early extinguishment of debt of \$5,252 in regard to refinancing and amending our credit facility. There was no similar expense in 2003.
- Other, net decreased \$285 principally due to a \$325 reduction in a patronage dividend received as a borrower from a cooperative bank offset by increased interest income and initial principal payment collected on the note receivable from the sale of Conestoga Wireless.

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Income Taxes

Federal and state income taxes were an expense of \$5,806 in 2005 on the \$19,582 income from continuing operations compared to the 2004 income tax expense of \$1,430 on the loss from continuing operations of \$1,244. Income taxes for 2005 include expense of \$1,899 as a result of the increase to our deferred tax liabilities calculated at the federal statutory rate of 35% compared to 34% in prior years. The effective tax rates were 29.6% in 2005 and a negative 115.0% in 2004.

Federal and state income taxes were an expense of \$1,430 in 2004 on the \$1,244 loss from continuing operations and a tax expense of \$1,968 on the \$5,910 income from continuing operations in 2003. The 2004 tax expense reflects tax on income in the United States while the Pilicka asset impairment and the impairment of our investment in EuroTel created a deferred tax deduction that may not be realizable. The effective tax rates were a negative 115.0% in 2004 and 33.3% in 2003.

Discontinued Operations, Extraordinary Items and Accounting Changes

The loss from discontinued operations of \$53 in 2003 was from our paging operation which was sold in May 2003.

We adopted Statement of Financial Accounting Standard No. 143 "Accounting for Asset Retirement Obligations" effective January 1, 2003 and recorded an after-tax benefit of \$260 as a cumulative effect accounting adjustment in the first quarter 2003. The adjustment represents the cumulative estimate of cost of removal charged to depreciation expense in earlier years for which D&E does not have a legal obligation associated with the retirement of the related tangible long-lived assets.

Accelerated Vesting of Stock Options

On December 21, 2005, the Executive Committee of the D&E Board of Directors approved the accelerated vesting of certain employee stock options that were granted under the 1999 Long-Term Incentive Plan of D&E Communications, Inc. or the Conestoga Enterprises, Inc. 1999 Stock Option Plan, which would have been unvested as of December 31, 2005 and had exercise prices greater than the closing price at December 20, 2005 of \$8.41 per share. As a result of this acceleration of the vesting, options to purchase 22,041 shares of our common stock became exercisable immediately. The number of shares, exercise prices and other terms of the options subject to the acceleration remain unchanged. The decision to accelerate the vesting of these options was made to reduce non-cash compensation expense that would have been recorded in our income statement in future periods upon the adoption of Financial Accounting Standards Board Statement No. 123R, "Share-Based Payment," in January 2006. We estimate that, as a result of this action, we will not be required to recognize anticipated compensation expense relating to stock options, net of taxes, of approximately \$38 in 2006 and \$19 in 2007.

Effects of Inflation

It is the opinion of management that the effects of inflation on operating expenses over the past three years have been immaterial. Management anticipates that this trend will continue in 2006.

Financial Condition

Liquidity and Capital Resources

We have historically generated significant cash from our operating activities. Our overall capital resource strategy is to finance capital expenditures for new and existing lines of businesses with operating cash and to finance acquisitions through external sources, such as bank borrowings and offerings of debt or equity securities.

Net cash provided by continuing operations was \$41,613 in 2005, \$49,595 in 2004 and \$45,009 in 2003. The primary reason for the decrease from 2004 to 2005 was the collection of an income tax refund of \$3,065 in 2004 with no similar refund collected in 2005 and an increase in income tax payments of \$5,720 in 2005 over

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2004. In 2004 the increase was primarily attributable to a reduction of accounts receivable. Heightened competition in the telecommunications industry could affect future cash flows related to continuing operations. See "Business Risks."

Net cash used in investing activities was \$20,344 in 2005 and consisted primarily of \$30,854 for capital expenditures and advances to affiliates of \$315 offset by \$7,762 received from sale of investments, repayments from affiliates of \$1,563 and \$1,500 collected on the note receivable from the sale of the assets of Conestoga Wireless. The capital additions by major categories and the approximate dollars spent on each were:

- digital switching and circuit equipment, computers and software, and poles and cable purchases to upgrade our RLEC and CLEC operating systems — \$19,900;
- computers and software separate from the telephone network operations primarily for upgrades to our operating systems, a service call management system and a mapping system for our RLEC and CLEC network facilities — \$8,300.

Net cash used in investing activities was \$25,736 in 2004 and consisted primarily of \$25,248 for capital expenditures and a net \$613 investment in affiliates offset by \$125 collected on the note receivable from the sale of the assets of Conestoga Wireless. The capital additions by major categories and the approximate dollars spent on each were:

- digital switching and circuit equipment, computers and software, and poles and cable purchases to upgrade our RLEC and CLEC operating systems — \$15,200;
- computers and software separate from the telephone network operations primarily for an upgrade to our operating system and software for the billing system and expanded office locations — \$8,300.

Net cash used in investing activities was \$9,512 in 2003 and consisted primarily of \$20,153 for capital expenditures, offset by \$12,475 from the sale of businesses and investments. The capital additions by major categories and the approximate dollars spent on each were:

- digital switching and circuit equipment, computers and software, and poles and cable purchases to upgrade our RLEC and CLEC operating systems — \$13,200;
- computers and software separate from the telephone network operations primarily for an upgrade to our operating system and software for the billing system and expanded office locations — \$3,400;
- Internet e-mail software upgrade and modems — \$1,400;
- Video equipment — \$1,800.

Cash used in financing activities in 2005 was \$19,461, consisting primarily of payments on long-term debt of \$13,000, dividend payments of \$6,825 offset by \$364 received for new shares of common stock issued. The payments on long-term debt of \$13,000 consisted of scheduled payments of \$10,000 and a voluntary prepayment of \$3,000.

Cash used in financing activities in 2004 was \$27,788, consisting primarily of \$13,335 for the purchase of 1,333,500 shares of treasury stock offset by \$430 received for new shares of common stock issued. Additionally, \$7,122 was used for payment of dividends and \$5,266 was used for a net long-term debt reduction. Debt issuance costs of \$2,495 were paid related to the refinancing and amendment of our credit facility in 2004.

Cash used in financing activities in 2003 was \$18,183, consisting primarily of \$23,332 for payments on long-term borrowing, offset by additional borrowings of \$12,000. Payment of dividends used \$7,408, and \$1,037 of cash was received from issuing common stock.

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External Sources of Capital at December 31, 2005

On March 5, 2004, we completed a syndicated senior secured debt financing in the amount of \$260,000. The credit facilities are in the form of a \$25,000 Revolving Loan, Term Loan A in the amount of \$50,000, Term Loan B in the amount of \$150,000, and the assumption of \$35,000 of term indebtedness of a D&E subsidiary. The \$200,000 of proceeds received related to the term loans of the new credit facilities were used to refinance indebtedness under prior credit facilities and for general corporate purposes. On November 22, 2004, we entered into an amendment with respect to this senior financing. The amendment reduced the Term Loan B U.S. prime rate margin and LIBOR margin to 1.00% and 2.00%, respectively. As a result of the refinancing and subsequent amendment, we incurred a loss on the early extinguishment of debt of \$5,252, consisting of a non-cash write-off of \$4,949 of unamortized debt issuance costs of the previous credit facility and the expensing of \$303 of debt issuance costs related to the new credit facility and the amendment. We capitalized approximately \$2,293 of debt issuance costs related to the new credit facility and the amendment, which will be amortized into interest expense over the life of the new credit facility.

The Senior Secured Revolving Loan ("Revolving Loan") is a \$25,000 senior secured reducing revolving credit facility maturing June 30, 2011. The Revolving Loan requires interest only payments at our option at either the U.S. prime rate plus 1.00% to 1.75% or a one, two, three or six month LIBOR rate plus 2.00% to 2.75% depending on the Company's leverage ratio. At December 31, 2005, the average interest rate was 6.87%. The Revolving Loan will reduce permanently to \$15,000 on December 31, 2006. The Revolving Loan also requires a quarterly commitment fee on the unused portion.

The Senior Secured Term Loan A ("Term Loan A") is a \$50,000 term note maturing June 30, 2011. Term Loan A bears interest at our option at either the U.S. prime rate plus 1.00% to 1.75% or a one, two, three or six month LIBOR rate plus 2.00% to 2.75%, depending on the Company's leverage ratio. At December 31, 2005, the average interest rate was 7.15%. Term Loan A requires increasing quarterly principal payments which began in the first quarter of 2004 and continue through the second quarter of 2011.

The Senior Secured Term Loan B ("Term Loan B") is a \$150,000 term note maturing December 31, 2011. Term Loan B bears interest at our option at either the U.S. prime rate plus 1.00% or a one, two, three or six month LIBOR rate plus 2.00%, regardless of the Company's leverage ratio. At December 31, 2005, the average interest rate was 6.22%. Term Loan B requires quarterly principal payments of \$375 which began in the first quarter of 2004 through the fourth quarter of 2010, three quarterly principal payments of \$34,875 in 2011 and a final principal payment of \$33,314 on December 31, 2011.

The 9.34% Secured Term Loan in the amount of \$20,000 was assumed as a result of the Conestoga acquisition. The 9.34% Secured Term Loan requires interest to be paid quarterly at the stated rate and also requires principal to be paid in quarterly installments of \$500 which began in 2005 and continue through 2014.

The 9.36% Secured Term Loan in the amount of \$15,000 was assumed as a result of the Conestoga acquisition. The 9.36% Secured Term Loan requires interest to be paid quarterly at the stated rate and also requires principal to be paid in quarterly installments of \$375 which began in 2005 and continue through 2014.

As of December 31, 2005, \$18,000 of the Revolving Loan was available for borrowing without violating any of the covenants. Our ratio of total debt to total debt plus capital decreased to 53.7% at December 31, 2005 from 56.3% at December 31, 2004 due to the increase in shareholders' equity and decrease in long-term debt during 2005.

The refinanced credit facility has no restrictions on expansion of our edge-out market areas and no excess cash flow payment requirement. Excess cash flow for the fourth quarter of 2003 required a payment of \$4,350 on the Revolving Loan on February 13, 2004. The cash balance was sufficient to make the excess cash flow payment and that reduction of debt added to the funds borrowed upon closing of the \$260,000 refinancing. The

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refinanced credit facility continues to include a number of significant covenants that impose restrictions on our business. These covenants include, among others, a limit of \$10,000 in annual dividend payments, and restrictions upon additional indebtedness, mergers, acquisitions, the disposition of assets, sale and leaseback transactions and capital lease payments.

	Ratios	December 31, 2005 Requirement
Total Leverage Ratio = Indebtedness divided by Cash Flow		<4.00
Decreases to < 3.75 after January 1, 2006		
Decreases to < 3.50 after July 1, 2006		
Decreases to < 3.00 after January 1, 2007		
Decreases to < 2.75 after January 1, 2008		
Total Indebtedness to Total Capitalization Ratio		<60%
Debt Service Coverage = Cash Flow divided by Proforma Debt Service		>1.75
Last year Cash Flow / next year's Debt Service		
Cash Flow divided by Fixed Charges		>1.05
Principal repayments		
2006		\$ 10,000
2007		\$ 12,500
2008		\$ 12,500
2009		\$ 12,500
2010		\$ 9,061
Thereafter		\$ 158,939

Note for covenant calculations that Cash Flow uses the definition of "Operating Cash Flow" which means the sum of (i) net income or deficit, as the case may be (excluding extraordinary gains, extraordinary losses (including without limitation, any realization of the unamortized debt issuance cost from the Current Credit Agreement), the non-cash write up or write down of any asset), (ii) total interest expense (including non-cash interest), (iii) depreciation and amortization expense and other similar non-cash expenses, (iv) taxes, federal or state, imposed upon income and (v) non-cash employee and director compensation. For any period of calculation, Operating Cash Flow shall be adjusted to give effect to any acquisition, sale or other disposition of any operation of business (or any portion thereof) during the period of calculation as if such acquisition, sale or other disposition occurred on the first day of such period of calculation. Further, the definition of fixed charges no longer includes dividend payments.

In light of the favorable market conditions and opportunities which appear to be available to the Company due to its performance, we are considering alternatives available to us to take advantage of low market interest rates and to amend existing loan amortization schedules and/or loan covenants. There is no assurance that our evaluation of the alternatives will result in a favorable restructuring of or amendment to our indebtedness.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company has not entered into any transactions with unconsolidated entities whereby the Company has financial guarantees, subordinated retained interest or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company.

Except for operating leases listed in the table of commitments below, the Company has no off-balance sheet:

- obligation under a guarantee contract;
- contingent interest in assets transferred to an unconsolidated entity;

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- obligation under a contract that would be accounted for as a derivative instrument;
- obligation arising out of a variable interest in an unconsolidated entity held by the Company.

Commitments, Contingencies and Projected Uses of Capital

Our most significant commitment for 2006 other than for operations, include capital expenditures, the payment of common stock dividends, when and if declared, payment of principal and interest on our outstanding debt and other contractual obligations and commitments which are presented below. Scheduled principal payments totaling \$10,000 are due in 2006. We believe that we will have sufficient resources to meet these commitments, contingencies and projected uses of funds.

We hold a 33.3% interest in EuroTel which we account for under the equity method of accounting. Neither the assets nor the liabilities of EuroTel are presented on a consolidated basis on our balance sheets. We have committed to fund EuroTel, on an equal basis with the other investors in EuroTel, for certain of its operating cash needs and will continue to recognize our equity share of their ongoing losses. In 2005, we made advances of \$315 pursuant to this commitment and expect that our 2006 funding requirements for EuroTel will be approximately \$750.

At December 31, 2005, the long-term debt maturing within one year consisted of principal payments of \$5,000 on Term Loan A, \$1,500 on Term Loan B and \$3,500 on the secured fixed rate term loans.

The following table sets forth our contractual obligations and the periods in which payments are due:

Obligation	Payments Due by Period				
	Total	Year 1	Years 2-3	Years 4-5	After 5 Years
Debt maturing within one year	\$ 10,000	\$10,000	\$ —	\$ —	\$ —
Long-term debt	205,500	—	25,000	21,561	158,939
Interest expense	81,090	14,753	29,240	26,940	10,157
Operating leases	1,139	666	307	70	96
Purchase commitments	18,427	6,853	7,149	2,685	1,740
Total	<u>\$316,156</u>	<u>\$32,272</u>	<u>\$61,696</u>	<u>\$51,256</u>	<u>\$ 170,932</u>

Debt maturing within one year and long-term debt listed above is only principal and does not include required interest payments. We have contract commitments to purchase telecommunication services for the use of third-party network circuits, to purchase telecommunications equipment and to maintain minimum monthly volumes for long distance call delivery services. These commitments represent the total gross payments due under contract. We expect to contribute \$3,500 and \$3,800 to our pension plan during 2006 and 2007, respectively.

Critical Accounting Policies and Estimates

Our discussion and analysis of our results of operations and financial condition is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of the financial statements requires us to make estimates and judgments that affect the reported amounts. On an on-going basis, we evaluate our estimates, including those related to intangible assets, income taxes, revenues, contingencies and impairment of long-lived assets. We base our estimates on historical experience and other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions, as further described below.

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Note 2 to the consolidated financial statements provides a summary of all significant accounting policies that we follow in the preparation of our financial statements. We have identified the following critical accounting policies as those that are the most significant to our financial statement presentation and that require difficult, subjective and complex judgments.

Revenue Recognition

Revenue for all of our business segments is recorded when services are provided or products are delivered, when the price is fixed or determinable, persuasive evidence of an arrangement exists, and the collectibility of the resulting receivable is reasonably assured. Our RLEC and CLEC pricing is subject to oversight by both state and federal regulatory commissions.

Such regulation also covers services, competition and other public policy issues. Different interpretations by regulatory bodies may result in adjustments in future periods to revenues derived from our RLEC and CLEC operations. We monitor these proceedings closely and make adjustments to revenue accordingly.

We receive a portion of our interstate access revenues in our RLEC segments from settlement pools in which we participate with other telephone companies through NECA. These pools were established at the direction of the FCC and are funded by interstate access service revenues, which the FCC regulates. Revenues earned through this pooling process are initially recognized based on estimates and are subject to adjustments that may either increase or decrease the amount of interstate access revenues. If the actual amounts that we receive from or pay into the settlement pools differ from the amounts that we have recorded as accounts receivables or accrued liabilities on our balance sheets, we are required to record the amount of such a reduction or increase as an adjustment to our earnings. In 2005, we recorded an increase in communications service revenue of approximately \$601 as a result of a change in our estimated interstate revenue earned from the NECA pooling process. Our estimate is based on an FCC rule that mandates that refunds payable to long distance communication providers are not required for periods in which interstate rate-of-return exceeds FCC authorized levels if the rates for those periods were deemed to be lawful rates. In 2004 and 2003, we recorded communication service revenue of \$163 and \$244, respectively, related to this estimate.

Regulated Asset Depreciation

We use a composite group remaining life method and straight-line composite rates to depreciate the regulated property assets of our RLEC and CLEC segments. Under this method, when we replace or retire such assets, the original cost of the asset, net of any salvage, is charged to accumulated depreciation. The effect of this accounting is to amortize any gains or losses on dispositions over the service lives of the remaining regulated telephone property assets rather than recognizing such gain or loss in the period of retirement.

In addition, use of the composite group remaining life method requires that we periodically revise our depreciation rates. Such revisions are based on asset retirement activity, and often require that we make related estimates and assumptions. If actual outcomes differ from our estimates and assumptions, we may be required to adjust depreciation and amortization expense, which could impact our earnings. During 2005, we revised the estimated useful lives of certain fixed assets to update composite rates for our regulated telephone property. This change resulted in lower depreciation expense in 2005 of approximately \$3,304. In 2006, we anticipate this change will result in lower depreciation expense of approximately \$5,341.

Impairment of Long-Lived Assets

Long-lived assets, including our property, plant and equipment and our finite-lived intangibles, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable in accordance with SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived

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Assets.” Recoverability is assessed based on future cash flows expected to result from the use of the asset and its eventual disposition. If the sum of the undiscounted cash flows is less than the carrying value of the asset, an impairment loss is recognized. Any impairment loss, if indicated, would be measured as the amount by which the carrying amount of the asset exceeds the estimated fair value of the asset. While we have never recorded a material impairment charge for long-lived assets, future events or changes in circumstances could result in a material charge to earnings.

Impairment of Goodwill and Indefinite-Lived Intangibles

In accordance with SFAS No. 142, “Goodwill and Other Intangible Assets,” goodwill and indefinite-lived intangibles are no longer subject to amortization. Goodwill and indefinite-lived intangibles are subject to at least an annual assessment for impairment by comparing carrying value to fair value. There is a two-step process for goodwill. The first step is to identify a potential impairment by comparing the fair value of reporting units to their carrying value. If the results of the first step of the impairment testing indicate a potential impairment, the second step would be completed to measure the amount of any impairment loss. We continually evaluate whether events and circumstances have occurred that indicate the remaining balances of goodwill and indefinite-lived intangibles may not be recoverable. In evaluating impairment, we estimate the sum of the expected future cash flows derived from such goodwill and indefinite-lived intangibles. Such evaluations for impairment are significantly impacted by estimates of future revenues, costs and expenses, the market price of our stock and other factors. While we have never recorded a material impairment charge for goodwill and indefinite-lived intangibles, future events or changes in circumstances could result in a material charge to earnings.

Investment in Unconsolidated Affiliates

We have investments and advances to affiliated entities that are accounted for under the equity method of accounting. We periodically evaluate whether there have been declines in value in these investments, and if so, whether these declines are considered temporary or other-than-temporary. Other-than-temporary declines would be recognized as realized losses in earnings. Evidence of a loss in value includes, but is not limited to, our inability to recover the carrying amount of the investment or the inability of the investee to sustain an earnings capacity, which would justify the carrying amount of the investment. The fair value of an investment that is less than its book value may indicate a loss in value of the investment. Our evaluations are based on many factors, including the duration and extent to which the fair value is less than carrying amount; the financial health of and business outlook for the investee, including industry performance, changes in technology, and operational and financing cash flow factors; and our intent and ability to hold the investment, including strategic factors.

Retirement Benefits

Retirement benefits are a significant cost of doing business and yet represent obligations that will be settled in the future. Retirement benefit accounting is intended to reflect the recognition of future benefit costs over the employee’s approximate service period based on the terms of the plans and the investment and funding decisions made by a company. We record the costs of providing retirement benefits in accordance with SFAS No. 87 “Employers’ Accounting for Pensions.” In December 2003, we adopted SFAS No. 132R, “Employers’ Disclosures about Pensions and Other Postretirement Benefits,” which provides expanded disclosures related to our employee benefit plans. Our estimates include assumptions regarding the discount rate to value the future obligation and the expected return on our plan assets. We use discount rates in line with current market interest rates on high quality fixed rate debt securities. Our return on assets is based on our current expectation of the long-term returns on assets held by the plan. Changes in these key assumptions can have a significant impact on the projected benefit obligations, funding requirements and periodic benefit costs that we incur. Our pension expense for 2005 would have increased approximately \$77 if our assumed investment return were one quarter of a percent lower. The expense would have increased approximately \$262 if our assumed discount rate were one quarter of a percent lower or decreased \$248 if our assumed discount rate were one quarter of a percent higher.

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Income Taxes

We file a consolidated federal income tax return. We have two categories of income taxes: current and deferred. Current taxes are those amounts we expect to pay when we file our tax returns. Since we must report some of our revenues and expenses differently for our financial statements than we do for income tax purposes, we record the tax effects of those differences as deferred tax assets and liabilities in our consolidated balance sheets. These deferred tax assets and liabilities are measured using the enacted tax rates that are currently in effect.

Management's judgment is required in determining the provision for current income taxes, deferred tax assets and liabilities, and any valuation allowance recorded against the net deferred tax assets. A valuation allowance is established for any deferred tax asset that we may not be able to use in the preparation and filing of our future tax returns. We have recorded a valuation allowance due to uncertainties related to the ability to utilize some of the deferred tax assets.

Recent Accounting Pronouncements

Effective December 31, 2005, the Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"). FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, "Accounting for Asset Retirement Obligations," refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Any uncertainty about the amount and/or timing of future settlement should be factored into the measurement of the liability when sufficient information exists. FIN 47 is effective for fiscal years ending after December 15, 2005. As of December 31, 2005, the Company has determined it does not have a material legal obligation to perform an asset retirement activity, thus the adoption of FIN 47 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). SFAS 123R revises FASB Statement No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. This standard requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments granted to employees (including stock options and discount stock purchase plans). SFAS 123R requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The compensation cost of the award is recognized over the period during which an employee is required to provide service, i.e. the requisite service period (usually the vesting period). In March 2005, the SEC issued Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"). SAB 107 provides further guidance based on the SEC staff views regarding the implementation of SFAS 123R.

On April 21, 2005, the SEC delayed the effective date of SFAS 123R. D&E will adopt SFAS 123R in January 2006 and will apply the modified prospective transition method. Under this method, a company records compensation expense for all new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation expense is recorded for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The cost of the unvested portion of the award is recognized as the requisite service is rendered on or after the required effective date. The adoption of SFAS 123R is not expected to have a material impact on our consolidated financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which changes the requirements for the accounting and reporting of a change in accounting principle. This

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statement requires retrospective application to reflect the period-specific effects of applying a new accounting principle, unless it is impracticable to determine. However, when a new accounting pronouncement is issued, the specific transition provisions of that guidance are applied. SFAS 154 is effective for fiscal years beginning after December 31, 2005 and is not expected to have a significant effect on the Company's financial position, results of operations or cash flows.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4," ("SFAS 151"), which clarifies the types of costs that should be expensed rather than capitalized as inventory. This statement also clarifies the circumstances under which fixed overhead costs associated with operating facilities involved in inventory processing should be capitalized. The provisions of SFAS No. 151 are applied prospectively and are effective for fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Item 7A. Quantitative and Qualitative Disclosure About Market Risks.

We are highly leveraged and, as a result, our cash flows and earnings are exposed to fluctuations in interest rates. Our debt obligations are U.S. dollar denominated. Our market risk, therefore, is the potential loss arising from adverse changes in interest rates and changes in our leverage ratio which may increase the margin added to the interest rate as provided in our loan agreement. As of December 31, 2005, our debt can be categorized as follows in thousands:

Fixed interest rates:	
Secured Term Loans	\$ 31,500
Subject to interest rate fluctuations:	
Senior Secured Revolving Credit Facility	7,000
Senior Secured Term Loans	177,000
Total debt	<u>\$215,500</u>

As part of our loan covenant conditions, we have arranged interest rate protection on a minimum of one-half of the total amount of senior indebtedness outstanding, with a weighted average life of at least 2 years. As of December 31, 2005, our debt is as follows:

	<u>Principal</u>	<u>Average Rate</u>	<u>Fair Value</u>
Rates fixed for four years through interest rate swaps	\$ 35,000	5.49%	\$ 35,000
Rates fixed for four years through interest rate swaps	15,000	5.98%	15,000
Rates fixed for four years through interest rate swaps	25,000	6.18%	25,000
Rates fixed for four years through interest rate swaps	35,000	6.88%	35,000
Fixed rate debt, rates fixed for twelve years	31,500	9.35%	35,045
Total fixed rates 66% of total debt	141,500	6.87%	145,045
Variable rate debt 34% of total debt	74,000	6.77%	74,000
Total debt	<u>\$215,500</u>		<u>\$219,045</u>

If interest rates rise above the rates of the variable debt, we could incur extra interest expense of \$370 for each 50 basis points above the current rates. If rates were to decline, we would realize reductions in interest expense of approximately \$370 for each 50 basis point decrease in rates.

The interest rate swaps were arranged to hedge against the effect of interest rate fluctuations. The swaps were arranged with banks that participate in our senior indebtedness. Under these interest rate swap contracts, we

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agree to pay an amount equal to a specified fixed-rate of interest times a notional principal amount and to receive in turn an amount equal to a specified variable-rate of interest times the same notional amount. The notional amounts of the contracts are not exchanged. Net interest positions are settled quarterly.

Terms of Swaps	Notional Amounts	Average Pay Rate	Average Received Rate	Fair Value Asset (Liability)
11/25/02 to 11/25/06	\$ 35,000	5.49%	6.39%	\$ 423
11/26/04 to 11/26/08	15,000	5.98%	6.39%	318
06/30/05 to 08/26/09	25,000	6.18%	6.39%	491
12/16/05 to 12/06/09	35,000	6.88%	6.44%	(153)
	<u>\$110,000</u>			<u>\$ 1,079</u>

If interest rates rise above the rates fixed by these swaps, we could realize other income of \$550 for each 50 basis points above the fixed rates. If rates were to decline, we would realize other expense of approximately \$550 for each 50 basis point decrease in rates.

Our cash and cash equivalents consist of cash and highly liquid investments having initial maturities of three months or less. While these investments are subject to a degree of interest rate risk, it is not considered to be material.

Item 8. Financial Statements and Supplementary Data

Information called for by this Item is set forth beginning on page F-1. See Index to Financial Statements.

Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

There were no changes in or disagreements with accountants on accounting and financial disclosure.

Item 9A. Controls and Procedures

As of December 31, 2005, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to the Securities Exchange Act of 1934 ("Exchange Act"), Rules 13a-15(e). Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in Company reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. These controls and procedures, without limitation, include controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based upon that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this Annual Report.

Based on an evaluation and assessment of internal controls over financial reporting, management has concluded that there was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) under the Exchange Act) during the quarter ended December 31, 2005 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404") requires D&E to include a report regarding the effectiveness of its internal control over financial reporting, in its Annual Report on Form 10-K for the year ending December 31, 2005. That report includes an assessment by D&E's management on the design and operating effectiveness of its internal control over financial reporting as of the end of the fiscal year. To comply with the requirements of Section 404, the Company designed and implemented a comprehensive compliance process to evaluate its internal control over financial reporting across the enterprise. Management's report and assessment on the effectiveness of its internal control over financial reporting is included herein on page F-2.

It should be noted that any system of controls, however well designed and operated, can provide only reasonable, and not absolute assurance that the objectives of the system are met. In addition, the design of any control system is based in part upon certain assumptions about the likelihood of future events. Because of these and other inherent limitations of control systems, there can be no assurance that any design will succeed in achieving its stated goals under all potential conditions, regardless of how remote.

Attached as exhibits to this Annual report are the certifications of the Chief Executive Officer and the Chief Financial Officer required in accordance with Rules 13a-14(a) of the Exchange Act. This section of the Company's Annual report includes the information concerning the controls evaluation referred to in the certifications and should be read in conjunction with the certifications for a more complete understanding of the topics presented.

Item 9B. *Other Information*

None

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The information required under this Item relating to Executive Officers is incorporated by reference from the material captioned "Directors," "Identification of Executive Officers," and "Section 16(A) Beneficial Ownership Reporting Compliance" in our definitive proxy statement for our annual meeting which will be filed within 120 days after the end of the fiscal year covered by this report.

Item 11. *Executive Compensation*

The information required under this Item is incorporated by reference from the material captioned "Executive Compensation" in our definitive proxy statement for our annual meeting which will be filed within 120 days after the end of the fiscal year covered by this report.

Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters*

The information required under this Item is incorporated by reference from the material captioned "Security Ownership of Management" and "Security Ownership of Certain Beneficial Owners" in our definitive proxy statement for our annual meeting which will be filed within 120 days after the end of the fiscal year covered by this report.

Item 13. *Certain Relationships and Related Transactions*

The information required under this Item is incorporated by reference from the material captioned "Certain Relationships and Related Transactions" in our definitive proxy statement for our annual meeting which will be filed within 120 days after the end of the fiscal year covered by this report.

Item 14. *Principal Accountant Fees and Services*

The information required under this Item is incorporated by reference from the material captioned "Audit Fees" in our definitive proxy statement for our annual meeting which will be filed within 120 days after the end of the fiscal year covered by this report.

Table of Contents**PART IV****Item 15. *Exhibits and Financial Statement Schedules***

(a) The following documents are filed as a part of this Annual Report on Form 10-K in the following manner:

(1) The consolidated financial statements of the Registrant and its subsidiaries filed as part of this report are listed in the attached Index to Financial Statements on page F-1.

(2) The financial schedules of the Registrant and its subsidiaries filed as part of this report are listed in the attached Index to Financial Statements on page F-1.

(3) The exhibits filed as part of this report are listed in the Index to Exhibits.

(b) *Exhibits*. See Index to Exhibits.

(c) Financial statement schedules of subsidiaries not consolidated and 50% or less owned. On February 8, 2006, the SEC granted a request for waiver made by the Registrant, of the audited financial statements for Pilicka as of and for the year ended December 31, 2005, and the unaudited financial statements for EuroTel as of and for the year ended December 31, 2005, which are required by Rule 3-09 of Regulation S-X. The remaining information called for by this Item (15) is set forth in the Index to Financial Statements on page F-1.

Table of Contents**INDEX TO EXHIBITS**

Exhibit No.	Identification of Exhibit	Reference
3.	Articles of Incorporation and By-laws:	
3.1	Amended and Restated Articles of Incorporation	Incorporated herein by reference from Exhibit 3.1 to D&E's Annual Report on Form 10-K for the year ended December 31, 2002.
3.2	By-laws	Incorporated herein by reference from Exhibit 3.1 to the Current Report on Form 8-K filed by D&E on December 8, 2004.
10.	Material Contracts	
10.1	AT&T Communications Standard Agreement for the Provision of Telecommunications Services and Facilities between AT&T Communications of Pennsylvania, Inc. and Denver and Ephrata Telephone and Telegraph Company; Article 1 General Provisions, effective May 25, 1984;	Incorporated herein by reference from Exhibit 10.2 to D&E's Registration Statement on Form 10 filed by D&E on April 30, 1993.
10.2	Telecommunications Services and Facilities Agreement between the Bell Telephone Company of Pennsylvania and Denver and Ephrata Telephone and Telegraph Company, effective January 1, 1986; and Amendment to Telecommunications Services and Facilities Agreement and the IntraLATA Compensation Agreement, dated May 7, 1992; Appendix 1 IntraLATA Telecommunications Services, effective January 1, 1986; Appendix 2 Ancillary Services, effective January 1, 1986; Appendix 5 Jointly Provided Feature Group A Compensation effective July 24, 1986; and Appendix 7 Extended Area Service, effective October 1, 1988.	Incorporated herein by reference from Exhibit 10.3 to D&E's Registration Statement on Form 10 filed by D&E on April 30, 1993.
10.3	IntraLATA Compensation Agreement between the Pennsylvania Non-Bell Telephone Companies and Denver and Ephrata Telephone and Telegraph Company, effective January 1, 1986; and Amendment to Telecommunications Services and Facilities Agreement and the IntraLATA Compensation Agreement, dated May 7, 1992.	Incorporated herein by reference from Exhibit 10.4 to D&E's Registration Statement on Form 10 filed by D&E on April 30, 1993.
10.4	Agreement for the Distribution of Interstate Access Revenues between the National Exchange Carrier Association, Inc. and Denver and Ephrata Telephone and Telegraph Company, effective May 25, 1984.	Incorporated herein by reference from Exhibit 10.6 to D&E's Registration Statement on Form 10 filed by D&E on April 30, 1993.

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Exhibit No.	Identification of Exhibit	Reference
10.5	Agreement for the Provision of Enhanced 9-1-1 Services between the County of Lancaster and Denver and Ephrata Telephone and Telegraph Company, effective upon approval of the Pennsylvania Public Utility Commission which occurred May 18, 1994	Incorporated herein by reference from Exhibit 10.7 to D&E's Annual Report on Form 10-K for the year ended December 31, 1999.
	Attachment #1 Request for Proposal as Amended;	
	Attachment #2 Best and Final Offer, April 28, 1994;	
	Attachment #3 Clarifications to RFP;	
	Attachment #4 Lancaster County	
	Resolution #74 September 22, 1993;	
	Attachment #5 Lancaster County	
	Resolution #32 May 5, 1994;	
	Attachment #6 Addenda, Errata, Bulletins to Contract Documents;	
	Attachment #7 Facility Lease; and	
	Attachment #8 Tariffed Local Exchange Carrier Services.	
10.6	Modification #2 to the Agreement for the Provision of Enhanced 9-1-1 Services between the County of Lancaster and D&E Telephone Company, signed July 14, 1999.	Incorporated herein by reference from Exhibit 10.1 to D&E's Quarterly Report on Form 10-Q for the quarter ended September 30, 1999.
10.7	Partnership Interest Purchase Agreement among D&E Wireless, Inc., D&E Communications, Inc., VoiceStream PA II, LLC, and VoiceStream PA I, LLC dated as of October 17, 2001.	Incorporated herein by reference from Exhibit 10.13 to D&E's Annual Report on Form 10-K for the year ended December 31, 2001.
10.8	2001 Stock Compensation Plan and Policy for non-employee Directors of D&E Communications, Inc.	Incorporated herein by reference from Exhibit A to D&E's definitive proxy statement for its 2001 Annual Meeting of Shareholders filed March 23, 2001.
10.9	Conestoga Enterprises, Inc. 1999 Stock Option Plan.	Incorporated herein by reference to Exhibit 99.1 to Form S-8 filed by D&E on May 24, 2002.
10.10	D&E Communications, Inc. Exempt Employee Short-Term Incentive Plan for 2005.	Incorporated herein by reference from Exhibit 99.1 to the Current Report on Form 8-K filed by D&E on March 2, 2005.
10.11	Asset Purchase Agreement by and among D&E Communications, Inc., Conestoga Wireless Company and Keystone Wireless, LLC dated November 12, 2002.	Incorporated herein by reference from Exhibit 2.1 to the Form 8-K current report filed by D&E on January 29, 2003.
10.12	Limited Guarantee Agreement dated June 29, 2001 by Conestoga Enterprises, Inc. with Mountain Union.	Incorporated herein by reference from Exhibit 10.19 to D&E's Annual Report on Form 10-K for the year ended December 31, 2002.

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Exhibit No.	Identification of Exhibit	Reference
10.13	Build-to-Suit Agreement dated June 29, 2001 by and between Conestoga Enterprises, Inc. on behalf of itself and its wholly-owned subsidiaries, Conestoga Mobile Systems, Inc. and Conestoga Wireless, Inc. and Mountain Union Telecom, LLC.	Incorporated herein by reference from Exhibit 10.20 to D&E's Annual Report on Form 10-K for the year ended December 31, 2002.
10.14	Credit Agreement Dated as of March 5, 2004 by and among D&E Communications, Inc. as borrower and CoBank, ACB as Administrative Agent, a CoLead Arranger and a Lender and other Lenders referred to therein.	Incorporated herein by reference from Exhibit 10.18 to Form 10-K for the year ended December 31, 2003.
10.15	Employment Agreement dated March 16, 2005 between James W. Morozzi and D&E Communications, Inc.	Incorporated herein by reference from Exhibit 99.3 to the Current Report on Form 8-K filed by D&E on March 16, 2005.
10.16	Share Purchase Agreement among EuroTel LLC, HunTel Systems, Inc., Consolidated Companies, Inc., D&E Investments, Inc. and MNI S.A. dated November 14, 2005.	Filed herewith.
10.17	D&E Communications, Inc. Exempt Employee Short-Term Incentive Plan for 2006.	Incorporated herein by reference from Exhibit 10.1 to the Current Report on Form 8-K filed by D&E on January 11, 2006.
10.18	Interconnection Agreement between D&E Systems, Inc. and Verizon North Inc., effective September 1, 2001.	Filed herewith.
10.19	Interconnection Agreement between D&E Systems, Inc. and Verizon Pennsylvania, Inc., effective September 1, 2001.	Filed herewith.
21.	Subsidiaries of the Registrant.	
21.1	List of all subsidiaries of D&E Communications, Inc.	Filed herewith.
23.	Consents.	
23.1	Consent of PricewaterhouseCoopers LLP, Philadelphia, PA.	Filed herewith.
23.2	Consent of Kiesling Associates LLP.	Filed herewith.
23.3	Consent of PricewaterhouseCoopers Sp. z o. o, Warsaw, Poland.	Filed herewith.
31.1	Certification of Chief Executive Officer.	Filed herewith.
31.2	Certification of Chief Financial Officer.	Filed herewith.
32.1	Certification of Chief Executive Officer.	Filed herewith.
32.2	Certification of Chief Financial Officer.	Filed herewith.

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Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 14, 2006

D&E COMMUNICATIONS, INC.

By: /s/ G. WILLIAM RUHL
G. William Ruhl
 Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ G. WILLIAM RUHL</u> G. William Ruhl	Chairman of the Board	March 14, 2006
<u>/s/ JAMES W. MOROZZI</u> James W. Morozzi	President and Chief Executive Officer (Principal executive officer)	March 14, 2006
<u>/s/ THOMAS E. MORELL</u> Thomas E. Morell	Senior Vice President, Chief Financial Officer and Treasurer (Principal financial and accounting officer)	March 14, 2006
<u>/s/ W. GARTH SPRECHER</u> W. Garth Sprecher	Senior Vice President, Secretary and Director	March 14, 2006
<u>/s/ JOHN AMOS</u> John Amos	Director	March 14, 2006
<u>/s/ PAUL W. BRUBAKER</u> Paul W. Brubaker	Director	March 14, 2006
<u>/s/ HUGH G. COURTNEY</u> Hugh G. Courtney	Director	March 14, 2006
<u>/s/ RONALD E. FRISBIE</u> Ronald E. Frisbie	Director	March 14, 2006
<u>/s/ ROBERT A. KINSLEY</u> Robert A. Kinsley	Director	March 14, 2006
<u>/s/ JOHN C. LONG</u> John C. Long	Director	March 14, 2006
<u>/s/ STEVEN B. SILVERMAN</u> Steven B. Silverman	Director	March 14, 2006
<u>/s/ D. MARK THOMAS</u> D. Mark Thomas	Director	March 14, 2006
<u>/s/ RICHARD G. WEIDNER</u> Richard G. Weidner	Director	March 14, 2006

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The management of D&E Communications, Inc. is responsible for the preparation and integrity of the Company's consolidated financial statements and all related information appearing in this Annual Report. Management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) under the Securities Exchange Act of 1934, and for performing an assessment of the effectiveness of internal control over financial reporting.

The Company maintains accounting and internal control systems which are intended to provide reasonable assurance as to the fair and reliable preparation and presentation of the consolidated financial statements, as well as to safeguard assets from unauthorized use or disposition. Management maintains internal controls to assure that transactions are executed in accordance with management's authorization and accounting records are reliable for preparing financial statements in accordance with accounting principles generally accepted in the United States of America. We are dedicated to maintain high standards of financial accounting and reporting and are committed to providing financial information that is transparent, timely, complete, relevant, and accurate. Our systems have been designed to provide reasonable, but not absolute assurance that financial records are adequate to allow for the completion of reliable financial information. Although there are inherent limitations in the effectiveness of any system of internal controls over financial reporting, we believe that these systems are adequate to achieve the stated objectives.

The Audit Committee of the Board of Directors oversees D&E's financial reporting process on behalf of the Board of Directors. The Audit Committee is composed solely of outside independent directors, and meets periodically with members of management and the independent auditors to review and discuss internal controls over financial reporting, the annual financial statement audit, and accounting and other financial reporting matters. The Company's internal control over financial reporting is also evaluated on an ongoing basis by its Internal Audit department.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rules 13a-15(f) of the Securities Exchange Act of 1934. Management performed an assessment of the effectiveness of our internal control over financial reporting based on the criteria in the *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. This evaluation included a review of the documentation of internal control over financial reporting and an evaluation of the design effectiveness of those controls. We also conducted testing on the design and operating effectiveness of our internal control over financial reporting. Based on our assessment, management has concluded that our internal control over financial reporting was effective as of December 31, 2005.

PricewaterhouseCoopers LLP, an independent registered public accounting firm has issued an audit report on management's assessment and on the effectiveness of internal control over financial reporting as of December 31, 2005, which is included herein. As stated in their report, PricewaterhouseCoopers LLP has also audited D&E's consolidated financial statements included in Item 8.

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To the Shareholders
of D&E Communications, Inc.:

We have completed integrated audits of D&E Communications, Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005, and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of D&E Communications, Inc. and its subsidiaries at December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, effective January 1, 2003, the Company changed its accounting for asset retirement obligations pursuant to the provisions of Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control — Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PRICEWATERHOUSECOOPERS LLP

Philadelphia, PA

March 10, 2006

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended December 31.		
	2005	2004	2003
	(In thousands, except per-share amounts)		
OPERATING REVENUES			
Communication service revenues	\$161,659	\$160,820	\$158,486
Communication products sold	11,652	12,656	12,255
Other	2,936	2,795	2,384
Total operating revenues	<u>176,247</u>	<u>176,271</u>	<u>173,125</u>
OPERATING EXPENSES			
Communication service expenses (exclusive of depreciation and amortization below)	65,922	65,049	60,846
Cost of communication products sold	8,692	10,100	9,317
Depreciation and amortization	38,745	39,119	38,626
Marketing and customer services	15,487	15,977	16,073
General and administrative services	24,742	25,079	24,496
Total operating expenses	<u>153,588</u>	<u>155,324</u>	<u>149,358</u>
Operating income	22,659	20,947	23,767
OTHER INCOME (EXPENSE)			
Equity in net income (losses) of affiliates	1,000	(3,172)	(2,537)
Interest expense	(14,177)	(14,389)	(18,074)
Gain (loss) on investments	6,895	(1,057)	790
Loss on early extinguishment of debt	—	(5,252)	—
Other, net	3,205	1,679	1,964
Total other income (expense)	<u>(3,077)</u>	<u>(22,191)</u>	<u>(17,857)</u>
Income (loss) from continuing operations before income taxes and dividends on utility preferred stock	19,582	(1,244)	5,910
INCOME TAXES AND DIVIDENDS ON UTILITY PREFERRED STOCK			
Income taxes	5,806	1,430	1,968
Dividends on utility preferred stock	65	65	65
Total income taxes and dividends on utility preferred stock	<u>5,871</u>	<u>1,495</u>	<u>2,033</u>
Income (loss) from continuing operations	13,711	(2,739)	3,877
Discontinued operations:			
Loss from operations of Paging business, net of income tax benefit of \$27	—	—	(53)
Income (loss) before cumulative effect of change in accounting principle	13,711	(2,739)	3,824
Cumulative effect of change in accounting principle, net of income taxes of \$177	—	—	260
NET INCOME (LOSS)	<u>\$ 13,711</u>	<u>\$ (2,739)</u>	<u>\$ 4,084</u>
Weighted average common shares outstanding (basic)	14,304	15,057	15,484
Weighted average common shares outstanding (diluted)	14,330	15,057	15,541
BASIC AND DILUTED EARNINGS (LOSS) PER COMMON SHARE			
Income (loss) from continuing operations	\$ 0.96	\$ (0.18)	\$ 0.25
Income (loss) from discontinued operations	—	—	—
Cumulative effect of accounting change	—	—	0.01
Net income (loss) per common share	<u>\$ 0.96</u>	<u>\$ (0.18)</u>	<u>\$ 0.26</u>
Dividends per common share	<u>\$ 0.50</u>	<u>\$ 0.50</u>	<u>\$ 0.50</u>

See notes to consolidated financial statements.

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands)

	December 31,	
	2005	2004
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 10,325	\$ 8,517
Accounts receivable, net of reserves of \$748 and \$1,024	16,864	16,495
Accounts receivable – affiliated company	351	75
Inventories, lower of cost or market, at average cost	3,645	3,523
Prepaid expenses	8,194	8,466
Other	1,243	2,465
TOTAL CURRENT ASSETS	<u>40,622</u>	<u>39,541</u>
INVESTMENTS		
Investments in and advances to affiliated companies	—	52
PROPERTY, PLANT AND EQUIPMENT		
In service	364,638	335,883
Under construction	7,334	8,768
	<u>371,972</u>	<u>344,651</u>
Less accumulated depreciation	192,259	162,078
	<u>179,713</u>	<u>182,573</u>
OTHER ASSETS		
Goodwill	145,448	149,032
Intangible assets, net of accumulated amortization	161,572	167,396
Other	8,317	8,191
	<u>315,337</u>	<u>324,619</u>
TOTAL ASSETS	<u>\$535,672</u>	<u>\$546,785</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES		
Long-term debt maturing within one year	\$ 10,000	\$ 10,000
Accounts payable and accrued liabilities	18,962	18,701
Accrued taxes	2,890	1,819
Accrued interest and dividends	1,791	1,683
Advance billings, customer deposits and other	11,087	11,585
TOTAL CURRENT LIABILITIES	<u>44,730</u>	<u>43,788</u>
LONG-TERM DEBT	<u>205,500</u>	<u>218,500</u>
OTHER LIABILITIES		
Equity in net losses of affiliates in excess of investments and advances	196	—
Deferred income taxes	79,063	86,402
Other	20,391	20,530
	<u>99,650</u>	<u>106,932</u>
PREFERRED STOCK OF UTILITY SUBSIDIARY, Series A 4 1/2%, par value \$100, cumulative, callable at par at the option of the Company, authorized 20 shares, outstanding 14 shares	<u>1,446</u>	<u>1,446</u>
COMMITMENTS AND CONTINGENCIES		
SHAREHOLDERS' EQUITY		
Common stock, par value \$0.16, authorized shares: 100,000 at December 31, 2005 and 2004 Outstanding shares: 14,345 at December 31, 2005 and 14,268 at December 31, 2004	2,554	2,542
Additional paid-in capital	160,924	160,255
Accumulated other comprehensive income (loss)	(5,598)	(6,574)
Retained earnings	45,083	38,513
Treasury stock at cost, 1,640 shares at December 31, 2005 and 2004	<u>(18,617)</u>	<u>(18,617)</u>

	<u>184.346</u>	<u>176.119</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$535.672</u>	<u>\$546.785</u>

See notes to consolidated financial statements.

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	<u>2005</u>	<u>2004</u> (In thousands)	<u>2003</u>
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$ 13,711	\$ (2,739)	\$ 4,084
Add: Loss from discontinued operations	—	—	53
Cumulative effect of accounting change	—	—	(260)
Income (loss) from continuing operations	<u>13,711</u>	<u>(2,739)</u>	<u>3,877</u>
Adjustments to reconcile net income (loss) from continuing operations to net cash provided by operating activities:			
Depreciation and amortization	38,745	39,119	38,626
Bad debt expense	485	551	745
Deferred income taxes	(3,756)	(1,892)	1,105
Equity in net income (losses) of affiliates	(1,000)	3,172	2,537
(Gain) loss on investments	(6,895)	1,057	(790)
Gain from cash recovery of note receivable	(1,500)	(125)	—
Loss on retirement of property, plant and equipment	53	171	209
Loss on early extinguishment of debt	—	5,252	—
Changes in operating assets and liabilities:			
Accounts receivable	(1,130)	3,835	(2,333)
Inventories	(122)	29	(77)
Prepaid expenses	272	448	(1,460)
Accounts payable and accrued liabilities	1,000	(1,061)	(1,300)
Accrued taxes and accrued interest	1,747	(567)	3,268
Advance billings, customer deposits and other	(497)	1,262	1,788
Other, net	<u>500</u>	<u>1,083</u>	<u>(1,186)</u>
Net Cash Provided by Operating Activities from Continuing Operations	<u>41,613</u>	<u>49,595</u>	<u>45,009</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures, net of proceeds from sales	(30,854)	(25,248)	(20,153)
Collection of note receivable	1,500	125	—
Proceeds from sale of businesses	—	—	10,005
Proceeds from sale of investments	7,762	—	2,470
Purchase of FCC licenses	—	—	(828)
Investments in and advances to affiliates	(315)	(767)	(1,232)
Investment returns and repayments from affiliates	<u>1,563</u>	<u>154</u>	<u>226</u>
Net Cash Used in Investing Activities from Continuing Operations	<u>(20,344)</u>	<u>(25,736)</u>	<u>(9,512)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Dividends on common stock	(6,825)	(7,122)	(7,408)
Proceeds from long-term debt financing	—	210,000	12,000
Payment of debt issuance costs	—	(2,495)	(101)
Payments on long-term debt	(13,000)	(215,266)	(23,332)
Payments on notes payable for acquired businesses	—	—	(379)
Proceeds from issuance of common stock	364	430	1,037
Purchase of treasury stock	—	(13,335)	—
Net Cash Used in Financing Activities from Continuing Operations	<u>(19,461)</u>	<u>(27,788)</u>	<u>(18,183)</u>
CASH PROVIDED BY (USED IN) CONTINUING OPERATIONS	<u>1,808</u>	<u>(3,929)</u>	<u>17,314</u>
CASH PROVIDED BY (USED IN) DISCONTINUED OPERATIONS			
Cash used in operating activities of discontinued operations	—	—	(20,553)
Cash provided by investing activities of discontinued operations	—	—	171
Net Cash Used in Discontinued Operations	—	—	<u>(20,382)</u>
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>1,808</u>	<u>(3,929)</u>	<u>(3,068)</u>
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<u>8,517</u>	<u>12,446</u>	<u>15,514</u>
CASH AND CASH EQUIVALENTS, END OF YEAR	<u><u>\$ 10,325</u></u>	<u><u>\$ 8,517</u></u>	<u><u>\$ 12,446</u></u>

See notes to consolidated financial statements.

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)

	Year Ended December 31,					
	2005		2004		2003	
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>
	(In thousands)					
COMMON STOCK						
Balance at beginning of year	15,908	\$ 2,542	15,854	\$ 2,533	15,721	\$ 2,512
Common stock issued for Employee Stock Purchase, Long-Term Incentive, Dividend Reinvestment and Stock Compensation Plan and Policy for Non-Employee Directors Plans	75	12	54	9	61	10
Common stock issued for stock options exercised	2	—	—	—	72	11
Balance at end of year	<u>15,985</u>	<u>2,554</u>	<u>15,908</u>	<u>2,542</u>	<u>15,854</u>	<u>2,533</u>
ADDITIONAL PAID-IN CAPITAL						
Balance at beginning of year		160,255		159,515		158,101
Common stock issued for Employee Stock Purchase, Long-Term Incentive, Dividend Reinvestment and Stock Compensation Plan and Policy for Non-Employee Directors Plans		652		740		772
Common stock issued for stock options exercised		17		—		642
Balance at end of year		<u>160,924</u>		<u>160,255</u>		<u>159,515</u>
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)						
Balance at beginning of year		(6,574)		(4,865)		(7,071)
Unrealized gain on investments, net of tax		—		—		723
Reclassification adjustment for realized gain on investments, net of tax		—		—		(498)
Equity adjustment for minimum pension liability, net of tax		173		(2,744)		1,777
Currency translation adjustment from EuroTel		—		57		—
Unrealized gain on derivative financial instruments, net of tax		803		978		204
Balance at end of year		<u>(5,598)</u>		<u>(6,574)</u>		<u>(4,865)</u>
RETAINED EARNINGS						
Balance at beginning of year		38,513		48,693		52,343
Net income (loss)		13,711		(2,739)		4,084
Dividends on common stock: \$.50 per share for each year		(7,141)		(7,441)		(7,734)
Balance at end of year		<u>45,083</u>		<u>38,513</u>		<u>48,693</u>
TREASURY STOCK						
Balance at beginning of year	(1,640)	(18,617)	(307)	(5,282)	(307)	(5,282)
Treasury stock acquired	—	—	(1,333)	(13,335)	—	—
Balance at end of year	<u>(1,640)</u>	<u>(18,617)</u>	<u>(1,640)</u>	<u>(18,617)</u>	<u>(307)</u>	<u>(5,282)</u>
TOTAL SHAREHOLDERS' EQUITY	<u>14,345</u>	<u>\$184,346</u>	<u>14,268</u>	<u>\$176,119</u>	<u>15,547</u>	<u>\$200,594</u>
COMPREHENSIVE INCOME (LOSS)						
Net income (loss)		\$ 13,711		\$ (2,739)		\$ 4,084
Unrealized gain on investments, net of income taxes of \$434		—		—		723
Reclassification adjustment for realized gain on investments, net of income taxes of (\$292)		—		—		(498)
Equity adjustment for minimum pension liability, net of income taxes of (\$44), (\$1,876) and \$1,214		173		(2,744)		1,777
Currency translation adjustment from EuroTel		—		57		—
Unrealized gain (loss) on derivative financial instruments, net of income taxes of \$566, \$668 and \$140		803		978		204
Total comprehensive income (loss)		<u>\$ 14,687</u>		<u>\$ (4,448)</u>		<u>\$ 6,290</u>

See notes to consolidated financial statements.

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per-share amounts)

1. Nature of Business**Description and Principles of Consolidation**

D&E Communications, Inc. (D&E or the Company) provides integrated communications services to residential and business customers in markets throughout the eastern half of Pennsylvania. D&E's consolidated financial statements include the accounts of Denver and Ephrata Telephone and Telegraph Company; Conestoga Telephone and Telegraph Company; Buffalo Valley Telephone Company; D&E Systems, Inc.; CEI Networks, Inc.; D&E Networks, Inc.; Infocore, Inc.; D&E Wireless, Inc.; Conestoga Wireless Company; D&E Investments, Inc.; Conestoga Mobile Systems, Inc. (see Note 8) and Conestoga Investment Corporation for all periods presented. All significant intercompany balances and transactions are eliminated in consolidation.

D&E's business segments are as follows: incumbent rural local exchange carrier (RLEC), competitive local exchange carrier (CLEC), internet services, systems integration, and corporate and other. In 2003, D&E moved responsibility for some products to different segment managers. The RLEC provides local and long distance telephone services in a franchised territory, including custom calling features and directory advertising. The CLEC provides telecommunication services in markets near those served by the RLEC. Internet services include internet access and web-hosting services. Systems integration provides consultation, design, implementation and maintenance of local and wide area networks and telecommunications systems. Corporate and other includes D&E's cable television operations in State College, PA, video operations in Lewisburg, PA, D&E's share of the earnings or losses of investments accounted for on the equity method, and the wireless telephony services of Conestoga Wireless Company (see Note 7).

D&E has a one-third interest in EuroTel, L.L.C. (EuroTel), a domestic corporate joint venture that held an investment in Pilicka Telefonía Sp. z o.o. (Pilicka), a telecommunications company located in Poland. D&E also owned a direct investment in Pilicka (see Note 5). On December 19, 2005, D&E sold its direct and indirect interest in Pilicka. D&E accounts for its investments in EuroTel and Pilicka using the equity method of accounting. Under the equity method, D&E reports its interest in the entity as an investment in its consolidated balance sheets and its percentage share of the earnings or losses from the entity in its consolidated statements of operations. D&E also owned an interest in PenTeleData Limited Partnership I until its sale on February 28, 2005. The investment in PenTeleData was reported at cost in other long-term assets on the consolidated balance sheets at December 31, 2004.

Regulatory Environment and Competition

D&E's RLEC and CLEC operations are subject to regulation at both the federal and state levels by the Federal Communications Commission (FCC) and the Pennsylvania Public Utility Commission (PUC). The passage of the Telecommunications Act of 1996 ("TA-96") provided comprehensive changes to federal and state regulations that govern telecommunications. On November 30, 2004, the Governor of Pennsylvania signed into law new Chapter 30 regulations that impacted D&E's RLECs. The law provides additional options to promote broadband deployment in the state and encourage faster rollout of broadband capability to all consumers. RLECs are required to spend capital dollars sooner to have broadband services available to all consumers by December 31, 2008. As an offset to the increased capital expenditure requirements, the new law removes the two percentage points reduction used to calculate intrastate rates annually. The new law adds other provisions to further the advancement of broadband services to schools in Pennsylvania and provides a suspension of certain interconnection requirements until December 31, 2008 to companies with less than 50,000 access lines, which have agreed to accelerate universal broadband deployment. Consequently, in D&E's two largest RLEC companies, competitors are still permitted to seek removal of the rural exemption from the more burdensome interconnection obligations for the purposes of entering those territories and using its services and facilities

Table of Contents**D&E COMMUNICATIONS, INC. AND SUBSIDIARIES**
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

through interconnection agreements to provide competitive services. However, they are unable to do so in Buffalo Valley's RLEC territory until after December 31, 2008.

D&E files its own tariff rates with the PUC for such services as dial-tone and custom calling features. D&E is a member of the National Exchange Carrier Association ("NECA") and participates in their pools for settlement of interstate access revenues.

D&E expects to experience an increasing amount of both competitive pressures and opportunities in its markets. No estimate can be made of the financial impacts of these changes.

Concentrations of Credit Risk

Financial instruments that subject D&E to concentrations of credit risk consist primarily of trade receivables. Concentrations of credit risk with respect to trade receivables are primarily limited due to the large number of residential and business customers in D&E's customer base. The systems integration segment receives a significant portion of its revenue from several large customers; however, none of these customers represent more than 10% of the company's revenue.

2. Significant Accounting Policies**Use of Estimates**

The preparation of financial statements under accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts or certain disclosures. Management bases its estimates on historical results and other assumptions that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. Estimates are used when accounting for the allowance for doubtful accounts, pension costs, intangible assets, NECA access revenues, depreciation expense, network access expenses and deferred income taxes.

Recent Accounting Pronouncements

Effective December 31, 2005, the Company adopted Financial Accounting Standards Board ("FASB") Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations" ("FIN 47"). FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, "Accounting for Asset Retirement Obligations," refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Any uncertainty about the amount and/or timing of future settlement should be factored into the measurement of the liability when sufficient information exists. FIN 47 is effective for fiscal years ending after December 15, 2005. As of December 31, 2005, the Company has determined it does not have a material legal obligation to perform an asset retirement activity, thus the adoption of FIN 47 did not have a material impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "Share-Based Payment" ("SFAS 123R"). SFAS 123R revises FASB Statement No. 123, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and its related implementation guidance. This standard requires all entities to recognize compensation expense in an amount equal to the fair value of share-based payments granted to employees (including stock options and discount stock purchase plans). SFAS 123R requires an entity to measure the cost of

Table of Contents**D&E COMMUNICATIONS, INC. AND SUBSIDIARIES**
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The compensation cost of the award is recognized over the period during which an employee is required to provide service, i.e. the requisite service period (usually the vesting period). In March 2005, the SEC issued Staff Accounting Bulletin No. 107, "Share-Based Payment" ("SAB 107"). SAB 107 provides further guidance based on the SEC staff views regarding the implementation of SFAS 123R.

On April 21, 2005, the SEC delayed the effective date of SFAS 123R. D&E will adopt SFAS 123R in January 2006 and will apply the modified prospective transition method. Under this method, a company records compensation expense for all new awards and to awards modified, repurchased, or cancelled after the required effective date. Additionally, compensation expense is recorded for the unvested portion of previously granted awards that remain outstanding at the date of adoption. The cost of the unvested portion of the award is recognized as the requisite service is rendered on or after the required effective date. The adoption of SFAS 123R is not expected to have a material impact on our consolidated financial position, results of operations or cash flows.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS 154"), which changes the requirements for the accounting and reporting of a change in accounting principle. This statement requires retrospective application to reflect the period-specific effects of applying a new accounting principle, unless it is impracticable to determine. However, when a new accounting pronouncement is issued, the specific transition provisions of that guidance are applied. SFAS 154 is effective for fiscal years beginning after December 31, 2005 and is not expected to have a significant effect on the Company's financial position, results of operations or cash flows.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of ARB No. 43, Chapter 4," ("SFAS 151") which clarifies the types of costs that should be expensed rather than capitalized as inventory. This statement also clarifies the circumstances under which fixed overhead costs associated with operating facilities involved in inventory processing should be capitalized. The provisions of SFAS No. 151 are applied prospectively and are effective for fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

In January 2003, D&E adopted SFAS No. 143, "Accounting for Asset Retirement Obligations" ("SFAS 143"). This Statement establishes accounting practices relating to legal obligations associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development or normal operation of a long-lived asset. SFAS 143 requires that companies recognize the fair value of a liability for asset retirement obligations in the period in which the legal obligations are incurred and capitalize that amount as a part of the book value of the long-lived asset. That cost is then depreciated over the remaining life of the underlying long-lived asset. D&E recorded an after-tax benefit of \$260 as a cumulative effect accounting adjustment in the first quarter 2003. The adjustment represents the cumulative estimate of cost of removal charged to depreciation expense in earlier years for which D&E does not have a legal obligation associated with the retirement of the related tangible long-lived assets. The adoption of this pronouncement had no material effect on D&E's ongoing financial position, results of operations or cash flows.

Revenue Recognition

The Company recognizes revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, "Revenue Recognition" and EITF 00-21, "Revenue Arrangements with Multiple Deliverables." Revenue is recognized when the service is rendered or the product is delivered, the price is fixed or determinable, persuasive evidence of an arrangement exists and the collectibility of the resulting receivable is reasonably assured. D&E's RLEC and CLEC pricing is subject to oversight by both state and federal regulatory

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commissions. Such regulation also covers services, competition and other public policy issues. Different interpretations by regulatory bodies may result in adjustments in future periods to revenues derived from D&E's RLEC and CLEC operations. D&E monitors these proceedings closely and makes adjustments to revenue accordingly. Certain non-recurring fees, such as service activation and installation fees, and associated incremental direct costs up to the amount of fees are deferred and recognized over the expected term of the customer relationship, which is deemed to be 3 to 8.5 years. Any direct costs in excess of fees deferred are expensed immediately.

The RLEC business segment receives a portion of its interstate access revenues from settlement pools in which it participates with other telephone companies through NECA. These pools were established at the direction of the FCC and are funded by access service charges, which the FCC regulates. Revenues earned through this pooling process are initially recognized based on estimates and are subject to adjustments that may either increase or decrease the amount of interstate access revenues. If the actual amounts that the Company receives from the settlement pools differ from the estimated amounts recorded, the Company records the change as a current adjustment to earnings. In 2005, the Company recorded an increase in communications services revenue of approximately \$601 as a result of a change in its estimated interstate revenue earned from the NECA pooling process. Our estimate is based on an FCC rule that mandates that refunds payable to long distance communication providers are not required for periods in which the interstate rate-of-return exceeds FCC authorized levels if the rates for those periods were deemed to be lawful rates. In 2004 and 2003, D&E recorded communications services revenue of \$163 and \$244, respectively, related to this estimate. D&E continues to monitor ongoing proceedings at the FCC and will evaluate and revise its estimates accordingly.

The systems integration long-term contracts are accounted for using the percentage-of-completion method, with revenues recognized in the proportion of costs incurred to total estimated costs at completion. Revenues on short-term projects that take less than three months to complete are recognized under the completed contract method.

Cash and Cash Equivalents

Cash and cash equivalents consist of all highly liquid investments purchased with an original maturity of three months or less. Cash balances may exceed F.D.I.C. insured limits at times.

Prepaid Directory

Directory advertising revenues and costs are deferred and amortized over the 12-month period related to the directory publication. Prepaid directory advertising costs, included in prepaid expenses, at December 31, 2005 and 2004 were \$6,072 and \$6,047, respectively. Deferred directory revenues, included in advance billings, customer deposits and other, at December 31, 2005 and 2004 were \$6,317 and \$6,819, respectively.

Investments In and Advances To Affiliated Companies and Equity in Net Losses of Affiliates in Excess of Investments and Advances

Investments in and advances to unconsolidated affiliates consist of the Company's investments in EuroTel, in Pilicka until its sale on December 19, 2005 and loans to EuroTel. The investments are accounted for under the equity method of accounting. The Company periodically evaluates whether there have been declines in value in these investments, and if so, whether these declines are considered temporary or other-than-temporary. Other-than-temporary declines would be recognized as realized losses in earnings. Evidence of a loss in value includes, but is not limited to, the Company's inability to recover the carrying amount of the investment or the inability of the investee to sustain an earnings capacity, which would justify the carrying amount of the investment. The fair

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value of an investment that is less than its book value may indicate a loss in value of the investment. The Company's evaluations are based on many factors, including the duration and extent to which the fair value is less than carrying amount; the financial health of and business outlook for the investee, including industry performance, changes in technology, and operational and financing cash flow factors; and the Company's intent and ability to hold the investment, including strategic factors.

Property, Plant and Equipment

Property, plant and equipment is stated at cost and depreciated using a composite group remaining life method and straight-line composite rates for the regulated telephone property of the RLEC and CLEC segments and the straight-line method of depreciation for other depreciable property. Use of the composite group remaining life method requires the periodic revision of estimated useful lives. Such revisions are based on fixed asset retirement activity, and often require related estimates and assumptions. The estimated useful lives on the majority of property, plant and equipment are 5 to 34 years for buildings, 5 to 18 years for digital switching equipment, 7 to 61 years for outside plant facilities and 2 to 39 years for other equipment. During 2005, D&E revised the estimated useful lives of certain fixed assets to update its composite rates for regulated telephone property. This change resulted in lower depreciation expense in 2005 of approximately \$3,304.

Depreciation expense as a percentage of average depreciable plant in service amounted to 9.5% in 2005, 10.1% in 2004 and 10.4% in 2003. The costs of maintenance and repairs are charged to operating expense.

When depreciable regulated telephone property is retired, the original cost of the asset, net of salvage, is charged to accumulated depreciation. Any gains or losses on disposition are amortized over the useful lives of the remaining regulated telephone property rather than recognizing such gain or loss in the period of retirement. When other depreciable property is retired, the gain or loss is recognized in the statement of operations.

Capitalized Interest

The cost of funds used to finance construction projects is reflected as part of the construction costs and a reduction of interest expense. Interest costs capitalized on assets were \$405 for 2005, \$323 for 2004 and \$228 for 2003.

Intangible Assets

Intangible assets represent the estimated value of franchises, acquired customer bases, trademarks and non-compete agreements at the dates of acquisitions. Franchise and FCC license intangible assets are determined to have indefinite lives. Finite-lived intangible assets are amortized over their estimated useful lives: 10 to 15 years for customer bases, 3 years for trademarks and 5 years for non-compete agreements.

Impairment of Long-Lived Assets

Long-lived assets, including property, plant and equipment and finite-lived intangibles, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Recoverability is assessed based on future cash flows expected to result from the use of the asset, or group of assets, and its eventual disposition. If the sum of the undiscounted cash flows is less than the carrying value of the asset, or group of assets, an impairment loss is recognized. Any impairment loss, if indicated, would be measured as the amount by which the carrying amount of the asset exceeds the estimated fair value of the asset, or group of assets.

Table of Contents**D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)****Impairment of Goodwill and Indefinite-Lived Intangibles**

In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," goodwill and indefinite-lived intangibles are no longer subject to amortization. Goodwill and indefinite-lived intangibles are subject to at least an annual assessment for impairment by comparing carrying value to fair value. There is a two-step process for goodwill. The first step is to identify a potential impairment by comparing the fair value of reporting units to their carrying value. If the results of the first step of the impairment testing indicate a potential impairment, the second step would be completed to measure the amount of any impairment loss. In April 2005, 2004 and 2003, the Company completed its annual impairment reviews and determined that no impairment charge was required. D&E continually evaluates whether events and circumstances have occurred that indicate the remaining balances of goodwill and indefinite-lived intangibles may not be recoverable. In evaluating impairment, D&E estimates the sum of the expected future cash flows derived from such goodwill and indefinite-lived intangibles. Such evaluations for impairment are significantly impacted by estimates of future revenues, costs and expenses, the market price of our stock and other factors.

Advertising

D&E expenses advertising costs as incurred. Advertising expense was \$1,680 for 2005, \$1,387 for 2004, \$1,991 for 2003.

Income Taxes

D&E files a consolidated federal income tax return. D&E has two categories of income taxes: current and deferred. Current taxes are those amounts D&E expects to pay when it files its tax returns. Since D&E must report some of its revenues and expenses differently for its financial statements than it does for income tax purposes, it records the tax effects of those differences as deferred tax assets and liabilities in its consolidated balance sheets. These deferred tax assets and liabilities are measured using the enacted tax rates that are currently in effect. A valuation allowance is established for any deferred tax asset for which management determines, based on the weight of available evidence, it is more likely than not that the deferred tax asset will not be realized.

Derivative Financial Instruments

D&E accounts for derivative financial instruments in accordance with SFAS No. 133, as amended. The Company's derivative financial instruments are comprised of interest rate swap agreements that the Company utilizes to manage changes in interest rate payments on its variable rate debt obligations. These derivative financial instruments, which qualify as cash flow hedges, are reflected on the balance sheet at their fair market value and changes in their fair value are reflected in Accumulated Other Comprehensive Income (Loss) and reclassified into interest expense as the underlying hedged variable rate interest payments are reflected in interest expense. The ineffective portion of the gain or loss on a derivative, if any, is recognized into earnings within other income or expense. No hedge ineffectiveness for existing derivative instruments has been recorded.

Earnings per Common Share

Basic earnings per common share is calculated by dividing net income (the numerator) by the weighted average number of common shares outstanding (the denominator) during the period. The computation of diluted earnings per share is similar to basic earnings per share except the denominator is increased to include the number of additional common shares that would have been outstanding for dilutive potential common shares. D&E has potential common shares as a result of outstanding stock option grants to purchase our common stock and contingently issuable shares of common stock. However, including potential common shares in the

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denominator of a diluted per-share computation for continuing operations always will result in an antidilutive per-share amount when D&E has a loss from continuing operations.

	For the years ended December 31,		
	2005	2004	2003
Income (loss) from continuing operations	\$13,711	\$ (2,739)	\$ 3,877
Loss from discontinued operations	—	—	(53)
Cumulative effect of accounting change	—	—	260
Net income (loss)	<u>\$13,711</u>	<u>\$ (2,739)</u>	<u>\$ 4,084</u>
Basic earnings per share:			
Weighted average shares outstanding (thousands)	<u>14,304</u>	<u>15,057</u>	<u>15,484</u>
Income (loss) from continuing operations	\$ 0.96	\$ (0.18)	\$ 0.25
Loss from discontinued operations	—	—	—
Cumulative effect of accounting change	—	—	0.01
Net income (loss) per common share	<u>\$ 0.96</u>	<u>\$ (0.18)</u>	<u>\$ 0.26</u>
Diluted earnings per share:			
Weighted average shares outstanding (thousands)	14,304	15,057	15,484
Incremental shares from assumed stock option exercises and contingently issuable shares (thousands)	<u>26</u>	<u>—</u>	<u>57</u>
Adjusted weighted average shares outstanding (thousands)	<u>14,330</u>	<u>15,057</u>	<u>15,541</u>
Income (loss) from continuing operations	\$ 0.96	\$ (0.18)	\$ 0.25
Income (loss) from discontinued operations	—	—	—
Cumulative effect of accounting change	—	—	0.01
Net income (loss) per common share	<u>\$ 0.96</u>	<u>\$ (0.18)</u>	<u>\$ 0.26</u>

Options to purchase 86,312, 221,358 and 70,104 shares as of December 31, 2005, 2004 and 2003, respectively, were not included in the computation of earnings per share assuming dilution because their effect on earnings per share would have been antidilutive. D&E had a loss from continuing operations during 2004 when common stock options were outstanding and, as such, diluted earnings per share in 2004 are equivalent to basic earnings per share.

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Stock-Based Compensation

The Company accounts for stock-based compensation under the intrinsic value method of APB Opinion 25, "Accounting for Stock Issued to Employees" and related interpretations. The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123, "Accounting for Stock-Based Compensation" to its stock-based employee compensation plans.

	Years Ended December 31,		
	2005	2004	2003
	(In thousands, except per share amounts)		
Net income (loss), as reported	\$13,711	\$(2,739)	\$4,084
Add: stock-based employee compensation included in reported net income (loss), net of related tax	105	—	—
Deduct: total stock-based employee compensation expense determined under fair value-based method, net of related tax	(220)	(39)	(50)
Pro forma net income (loss)	<u>\$13,596</u>	<u>\$(2,778)</u>	<u>\$4,034</u>
Basic earnings (loss) per share:			
As reported	\$ 0.96	\$ (0.18)	\$ 0.26
Pro forma	\$ 0.95	\$ (0.18)	\$ 0.26
Diluted earnings (loss) per share:			
As reported	\$ 0.96	\$ (0.18)	\$ 0.26
Pro forma	\$ 0.95	\$ (0.18)	\$ 0.26

The fair value of option grants of \$3.13 in the year ended December 31, 2005, was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

Dividend yield	5.05%
Expected life	5 years
Expected volatility	50.06%
Risk-free interest rate	4.18%

In 2005, there were 47,400 performance-restricted shares of common stock awarded and 2,667 shares forfeited due to a retirement. D&E accrues compensation cost related to these performance-restricted shares based upon the probability that the conditions to receive these shares are met. Also, in 2005, there were 2,297 fully-vested shares of common stock issued to employees of the Company. The expense related to the performance-restricted and fully-vested shares was \$175 in the year ended December 31, 2005. No shares of common stock were awarded to employees in 2004 and 2003.

On December 21, 2005, the Executive Committee of the D&E Board of Directors approved the accelerated vesting of certain employee stock options that were granted under the 1999 Long-Term Incentive Plan of D&E Communications, Inc. or the Conestoga Enterprises, Inc. 1999 Stock Option Plan, which would have been unvested as of December 31, 2005 and had exercise prices greater than the closing price at December 20, 2005 of \$8.41 per share. As a result of this acceleration of the vesting, options to purchase 22,041 shares of D&E's common stock became exercisable immediately. The number of shares, exercise prices and other terms of the options subject to the acceleration remain unchanged. The decision to accelerate the vesting of these options was made to reduce non-cash compensation expense that would have been recorded in D&E's income statement in future periods upon the adoption of SFAS No. 123R, "Share-Based Payment," in January 2006. The Company

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

estimates that, as a result of this action, it will not be required to recognize anticipated compensation expense relating to stock options, net of taxes, of approximately \$38 in 2006 and \$19 in 2007.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income or loss and other gains and losses affecting shareholders' equity that, under accounting principles generally accepted in the United States of America, are excluded from net income. Other gains and losses excluded from net income in D&E's financial statements include unrealized gains or losses on investments, an equity adjustment for a minimum pension liability, changes in the fair value of derivative financial instruments and the Company's share of currency translation adjustments from EuroTel and Pilicka.

Foreign Currency Translations and Transactions

The functional currency for PenneCom B.V. and Pilicka, D&E and EuroTel's foreign operations, is the local currency. For the foreign operations, EuroTel translated assets and liabilities at end-of-period exchange rates. EuroTel recorded these translation adjustments in accumulated other comprehensive income (loss), a separate component of equity in their balance sheets. For revenues, expenses, gains and losses, the average translation rate for the period is used to translate those elements. Foreign currency transaction gains and losses related to the foreign operations are reported in earnings. D&E records its share of EuroTel's foreign currency transaction gains and losses as part of its equity in net income or losses of affiliates. In addition, D&E has recorded its share of EuroTel's currency translation adjustments in accumulated other comprehensive income (loss).

Reclassifications

For comparative purposes, certain amounts have been reclassified to conform to the current-year presentation. The reclassifications had no impact on net income.

3. Cash Flow and Statement of Shareholders' Equity Information**Cash Flow Information**

Cash paid for income taxes and interest expense for the years ended December 31, was as follows:

	2005	2004	2003
Interest expense	\$13,293	\$13,694	\$16,134
Income taxes	7,707	1,987	24,310

Noncash investing and financing activities for the years ended December 31 were as follows:

	2005	2004	2003
Capital expenditures included in accounts payable at year end	\$ 961	\$ 1,700	\$ 445
Dividends reinvested in common stock	316	319	326

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
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Shareholders' Equity Information

At December 31, 2005 and 2004, accumulated other comprehensive income (loss) consisted of the following items:

	2005	2004
Equity adjustment for minimum pension liability, net of tax	\$(6,229)	\$(6,402)
Unrealized gain (loss) on derivative financial instruments, net of tax	631	(172)
Total accumulated other comprehensive income (loss)	<u>\$(5,598)</u>	<u>\$(6,574)</u>

4. Investments in and Advances to Affiliated Companies and Equity in Net Losses of Affiliates in Excess of Investments and Advances

D&E owns a one-third investment in EuroTel, a domestic corporate joint venture. EuroTel holds a 100% investment in PenneCom, B.V. (PenneCom), an international telecommunications holding company, and held a 27.85% investment in Pilicka, a telecommunications company located in Poland, until its sale on December 19, 2005 (See Note 5). D&E also owned a 28.88% direct investment in Pilicka until the sale on December 19, 2005. D&E accounts for both its investment in EuroTel and did account for its investment in Pilicka using the equity method of accounting.

Pilicka recognized an asset impairment late in 2004 requiring D&E to recognize a \$1,068 loss for its equity share of the impairment. Since D&E and EuroTel have no legal obligation or intention to provide future funding to Pilicka, both wrote their investment in Pilicka to zero and discontinued recognizing their equity share of Pilicka's ongoing losses. EuroTel no longer recorded any value to its investment in Pilicka and, therefore, the value of D&E's investment in EuroTel was written down as an other-than-temporary loss on investments of \$1,057. D&E has committed to fund certain of the operating cash needs of EuroTel, on an equal basis with the other investors and, accordingly, will continue to recognize its equity share of their ongoing losses; thereby, recognizing a liability of \$196 at December 31, 2005 which is reported in equity in net losses of affiliates in excess of investments and advances in the consolidated balance sheets.

In April 1999, PenneCom had entered into an agreement to sell its entire investment in Pilicka to Elektrim S.A. (Elektrim) for \$140,000 in cash and notes. In July 1999, Elektrim issued written notice to PenneCom that it was repudiating the purchase agreement. In August 1999, PenneCom filed an arbitration request with the International Court of Arbitration seeking specific performance of the agreement as well as compensatory and punitive damages. In 2001, an award of approximately \$40,000 plus interest at 10% per annum from August 1999 and reimbursement of arbitration costs was granted in favor of PenneCom. PenneCom used a portion of the proceeds to reduce outstanding loans with a domestic bank. In July 2002, PenneCom commenced an action in the United States District Court for the Southern District of New York against an investment bank and an individual. The action is currently pending in United States District Court. PenneCom's Amended Complaint asserted claims under Polish, Dutch and New York law against the defendants for their alleged tortious inducement of non-party Elektrim S.A. to breach a contract pursuant to which Elektrim S.A. would have purchased all of the shares of Pilicka Telefonica S.A. in August of 1999. Because a motion was granted to dismiss the claims that PenneCom had asserted pursuant to Polish and Dutch law, as well as a New York law fraud claim, the only claim currently being litigated is the tortious interference with contract claim asserted under New York law. The case is currently in discovery. No date has been set for trial. The outcome of the litigation cannot be determined and no amount has been recognized for possible collections of any claims. PenneCom will continue to incur legal costs in connection with this action.

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Prior to the sale of Pilicka, the equity investments in EuroTel and Pilicka were subject to the risks of foreign currency transactions, which were included in the results of PenneCom and Pilicka.

Summarized financial information for EuroTel is presented as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Years ended December 31:			
Equity in loss of affiliate	\$ —	\$ (2,560)	\$ (957)
Net income (loss)	3,000	(4,426)	(3,209)
At December 31:			
Current assets	\$ 81	\$ 199	
Noncurrent assets	1	1	
Current liabilities	30,635	33,753	
Members' equity (deficit)	(30,553)	(33,553)	

Summarized financial information for Pilicka is presented as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Years ended December 31:			
Net sales	\$12,258	\$ 14,131	\$10,548
Net income (loss)	446	(23,237)	(3,436)
At December 31:			
Current assets	\$ 7,123	\$ 6,164	
Noncurrent assets	21,380	25,471	
Current liabilities	2,180	2,405	
Noncurrent liabilities	53	745	
Shareholders' equity	26,270	28,485	

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
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A summary of changes for the investments in and advances to EuroTel, Pilicka and affiliates follows:

	2005	2004	2003
Investment in EuroTel:			
Beginning balance (deficit)	\$(12,278)	\$ (9,804)	\$ (8,697)
Equity in income (losses)	1,000	(1,474)	(1,107)
Equity in currency translation adjustments	—	57	—
Other-than-temporary loss on investment	—	(1,057)	—
Ending balance (deficit)	<u>(11,278)</u>	<u>(12,278)</u>	<u>(9,804)</u>
Advances to EuroTel and affiliates:			
Beginning balance	12,330	11,717	10,711
Advances	315	767	1,232
Repayments	<u>(1,563)</u>	<u>(154)</u>	<u>(226)</u>
Ending balance	<u>11,082</u>	<u>12,330</u>	<u>11,717</u>
Investment in Pilicka:			
Beginning balance	—	1,698	3,128
Equity in losses	—	(1,233)	(965)
Investments amortization	<u>—</u>	<u>(465)</u>	<u>(465)</u>
Ending balance	<u>—</u>	<u>—</u>	<u>1,698</u>
Investments in and advances to affiliates (Equity in net losses of affiliates in excess of investments and advances)	<u>\$ (196)</u>	<u>\$ 52</u>	<u>\$ 3,611</u>

In addition to loans, D&E provides support services to EuroTel and its affiliates. Amounts owed to D&E for services performed for EuroTel and affiliates at December 31, 2005 and 2004 were \$351 and \$75, respectively. These amounts are reported as accounts receivable-affiliated company.

5. Sale of Investment in Pilicka

On December 19, 2005, D&E, along with EuroTel and the other Pilicka shareholders, sold their ownership interests in Pilicka for an adjusted purchase price of \$16,835. D&E owned a 38.16% interest, 9.28% through its one-third interest in EuroTel, LLC, and 28.88% directly, in Pilicka. D&E recorded pre-tax income of \$4,852, net of sale costs, from the sale of its 28.88% direct investment, which is reported in gain (loss) on investments in the consolidated statement of operations. The pre-tax income from the sale of its 9.28% indirect investment amounted to \$1,563 and is reported in equity in net income (losses) of affiliates in the consolidated statement of operations.

6. Sale of Investments

On February 28, 2005, D&E sold its interest in PenTeleData Limited Partnership I for \$2,900 resulting in a gain of \$2,043 before taxes.

During the fourth quarter of 2003, D&E sold its entire portfolio of investments available-for-sale for \$2,470 and recorded a realized gain of \$790 before taxes.

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7. Sale of Conestoga Wireless Assets

In connection with the acquisition of Conestoga Enterprises, Inc. in May 2002, the Company had committed to a plan to sell the assets of Conestoga's wireless segment. As such, these assets were reported as held for sale in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets." The assets were not depreciated while they were held for sale.

On November 12, 2002, D&E entered into a definitive agreement to sell substantially all of the assets of the Conestoga wireless segment to Keystone Wireless, LLC ("Keystone"), a Delaware limited liability company. Keystone is an affiliate of PC Management, Inc., a Florida-based company that owns and manages wireless communications systems throughout the United States. The sale was completed on January 14, 2003. Upon completion of the sale, D&E received approximately \$10,000 in cash and a \$10,000 face value secured promissory note issued by Keystone. The promissory note requires monthly principal payments for 48 months beginning in January 2005. The note bears interest at the 60 day LIBOR rate plus 5% and is receivable beginning on December 31, 2003 and on the last day of each calendar quarter thereafter. As this note receivable is from a highly leveraged entity and the business sold had not generated positive cash flows, D&E records value to the note when cash recoveries are received. D&E received principal payments on the note of \$1,500 and \$125 in the years ending December 31, 2005 and 2004, respectively, which are reported in Other, net in the consolidated statements of operations. The note carried certain rights allowing conversion of a portion or all of the principal balance of the note into equity interests of Keystone. The conversion period began on December 31, 2004 and ended May 1, 2005. The Company did not exercise any of our conversion rights under this note.

The results of operations of the Conestoga wireless segment held for sale were not reported in discontinued operations because D&E has continuing involvement since the sale as a result of D&E's continued guarantees on cell site leases and D&E's responsibilities under a Build-to-Suit agreement which is more fully described in Note 14. No gain or loss was recorded as a result of the sale, however a loss of \$300 related to D&E's estimated commitments in the Build-to-Suit agreement was recorded in communication services expenses in 2003.

8. Discontinued Operations

In January 2003, D&E entered into an agreement to sell the paging operations' assets for \$215. The transaction closed for \$171 on May 29, 2003. The final selling price was less than anticipated and resulted in a \$29 net of tax asset impairment due to a smaller customer base on the date of sale than anticipated when the agreement was entered into. No liabilities were included as part of the sale.

The carrying amounts of the major classes of assets included as part of the paging operations sold are as follows:

Inventories	\$ 47
Property and equipment	<u>168</u>
Total assets sold	<u>\$215</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Summarized income statement information for the discontinued operations of the paging services were as follows:

	<u>2003</u>
Year ended December 31:	
Revenue	\$236
Expenses	<u>316</u>
Operating loss	(80)
Income tax benefit	<u>27</u>
Loss from paging operations, net of taxes	<u><u>\$ (53)</u></u>

9. Property, Plant and Equipment

Property, plant and equipment is summarized as follows at December 31:

	<u>2005</u>	<u>2004</u>
Land and buildings	\$ 53,505	\$ 52,979
Digital switching equipment	121,574	109,498
Outside plant facilities	129,075	124,172
Other equipment	60,484	49,234
Plant under construction	<u>7,334</u>	<u>8,768</u>
Total property, plant and equipment	371,972	344,651
Less accumulated depreciation	<u>(192,259)</u>	<u>(162,078)</u>
Property, plant and equipment, net	<u><u>\$ 179,713</u></u>	<u><u>\$ 182,573</u></u>

10. Goodwill and Intangible Assets

The goodwill and intangible assets are primarily the result of D&E's May 24, 2002 acquisition of Conestoga Enterprises, Inc., a neighboring rural local telephone company providing integrated communications services in markets throughout the eastern half of Pennsylvania.

In 2005, goodwill decreased \$3,566 due to a reclassification of certain deferred tax liabilities related to the Conestoga acquisition. Goodwill also decreased \$18 as a result of a reduction in a valuation allowance on deferred tax assets recognized in connection with the Conestoga acquisition.

In 2004, goodwill related to the Conestoga acquisition decreased \$95 as a result of a reduction in a valuation allowance on deferred tax assets recognized in connection with the Conestoga acquisition.

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
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Intangible assets and related accumulated amortization recorded on the Company's balance sheets are as follows:

	<u>2005</u>	<u>2004</u>
Indefinite-lived intangibles:		
Franchises	\$104,800	\$104,800
FCC licenses	828	828
Finite-lived intangibles:		
Customer relationships:		
Gross carrying amount	75,700	75,700
Accumulated amortization	(19,756)	(14,243)
Trademarks and trade names:		
Gross carrying amount	1,200	1,200
Accumulated amortization	(1,200)	(1,033)
Non-compete agreements:		
Gross carrying amount	1,424	1,424
Accumulated amortization	(1,424)	(1,280)
Net intangible assets	<u>\$161,572</u>	<u>\$167,396</u>

In December 2003, D&E acquired five FCC licenses for a cost of \$828. These licenses will allow the Company to provide wireless data services in Lancaster, Reading, Altoona, Williamsport, and State College, Pennsylvania. The licenses are deemed to have an indefinite life as there is an observable market and perfunctory renewal provisions.

Amortization expense related to intangible assets was \$5,824, \$6,198, and \$6,198 for the years ended December 31, 2005, 2004 and 2003, respectively. Estimated amortization expense for the succeeding five years is as follows:

<u>Year</u>	<u>Amount</u>
2006	\$5,513
2007	5,513
2008	5,513
2009	5,513
2010	5,513

11. Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities are summarized as follows at December 31:

	<u>2005</u>	<u>2004</u>
Trade payables	\$ 7,102	\$ 7,338
Accrued compensation	2,618	1,703
Accrued pension	3,133	2,733
Other	6,109	6,927
Total accounts payable and accrued liabilities	<u>\$18,962</u>	<u>\$18,701</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

12. Long-Term Debt

On March 5, 2004, D&E completed a syndicated senior secured debt financing in the amount of \$260,000. The credit facilities are in the form of a \$25,000 Revolving Loan, Term Loan A in the amount of \$50,000, Term Loan B in the amount of \$150,000, and the assumption of \$35,000 of term indebtedness of a D&E subsidiary. The \$200,000 of proceeds received related to the term loans of the new credit facilities were used to refinance indebtedness under prior credit facilities and for general corporate purposes. On November 22, 2004, D&E entered into an amendment with respect to this senior financing. The amendment reduced the Term Loan B U.S. prime rate margin and LIBOR margin to 1.00% and 2.00%, respectively. As a result of the refinancing and subsequent amendment, D&E incurred a loss on the early extinguishment of debt of \$5,252, consisting of a non-cash write-off of \$4,949 of unamortized debt issuance costs of the previous credit facility and the expensing of \$303 of debt issuance costs related to the new credit facility and the amendment. D&E capitalized approximately \$2,293 of debt issuance costs related to the new credit facility and the amendment, which will be amortized into interest expense over the life of the new credit facility.

Long-term debt at December 31 consisted of the following:

	December 31, 2005		2005	2004
	Interest Rate	Maturity		
Senior Secured Revolving Loan	6.87%	2011	\$ 7,000	\$ 10,000
Senior Secured Term Loan A	7.15%	2011	31,561	36,561
Senior Secured Term Loan B	6.22%	2011	145,439	146,939
Secured Term Loan	9.34%	2014	18,000	20,000
Secured Term Loan	9.36%	2014	13,500	15,000
			<u>215,500</u>	<u>228,500</u>
Less current maturities			10,000	10,000
Total long-term debt			<u>\$205,500</u>	<u>\$218,500</u>

The Senior Secured Revolving Loan ("Revolving Loan") is a \$25,000 senior secured reducing revolving credit facility maturing June 30, 2011. The Revolving Loan requires interest only payments at our option at either the U.S. prime rate plus 1.00% to 1.75% or a one, two, three or six month LIBOR rate plus 2.00% to 2.75% depending on the Company's leverage ratio. The weighted average annual interest rate for 2005 was 5.72%. The Revolving Loan will reduce permanently to \$15,000 on December 31, 2006. The Revolving Loan also requires a quarterly commitment fee on the unused portion.

The Senior Secured Term Loan A ("Term Loan A") is a \$50,000 term note maturing June 30, 2011. Term Loan A bears interest at the option of the Company at either the U.S. prime rate plus 1.00% to 1.75% or a one, two, three or six month LIBOR rate plus 2.00% to 2.75%, depending on the Company's leverage ratio. The weighted average annual interest rate for 2005 was 5.83%. Term Loan A requires increasing quarterly principal payments which began in the first quarter of 2004 and continue through the second quarter of 2011.

The Senior Secured Term Loan B ("Term Loan B") is a \$150,000 term note maturing December 31, 2011. Term Loan B bears interest at the option of the Company at either the U.S. prime rate plus 1.00% or a one, two, three or six month LIBOR rate plus 2.00%, regardless of the Company's leverage ratio. The weighted average annual interest rate for 2005 was 5.44%. Term Loan B requires quarterly principal payments of \$375 which began in the first quarter of 2004 through the fourth quarter of 2010, three quarterly principal payments of \$34,875 in 2011 and a final principal payment of \$33,314 on December 31, 2011.

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The 9.34% Secured Term Loan in the amount of \$20,000 was assumed as a result of the Conestoga acquisition. The 9.34% Secured Term Loan requires interest to be paid quarterly at the stated rate and also requires principal to be paid in quarterly installments of \$500 which began in 2005 and continue through 2014.

The 9.36% Secured Term Loan in the amount of \$15,000 was assumed as a result of the Conestoga acquisition. The 9.36% Secured Term Loan requires interest to be paid quarterly at the stated rate and also requires principal to be paid in quarterly installments of \$375 which began in 2005 and continue through 2014.

D&E's indebtedness requires the Company to maintain compliance with certain financial and operational covenants. The most restrictive covenant is the fixed charge coverage ratio. The covenants include a limit of \$10,000 in annual dividend payments. At December 31, 2005, D&E was in compliance with all covenants. D&E is also required to maintain interest rate protection on one-half of the total amount of senior indebtedness outstanding, with a weighted average life of at least 2 years. At December 31, 2005, \$141,500 of D&E's senior indebtedness was protected from interest rate fluctuations. Of this amount, \$31,500 of the Company's senior indebtedness has fixed interest rates. The Company also has interest rate swap agreements as interest rate protection for \$110,000 of debt (see Note 13). The loans are collateralized by D&E's personal property, mortgages on land and buildings with a value exceeding \$3,000, and the capital stock and guarantees of its subsidiaries.

Based on the borrowing rate currently available to the Company for bank loans, the fair market value of long-term debt at December 31, 2005 is \$219,045.

Maturities of long-term debt for each year ending December 31, 2006 through 2010 are as follows:

Year	Amount
2006	\$ 10,000
2007	12,500
2008	12,500
2009	12,500
2010	9,061
Thereafter	158,939

In June 2004, a long-term capital lease obligation of \$2,613 was eliminated in connection with the purchase of an office building previously held under a capital lease arrangement. The transaction did not materially impact the results of operations for the year ending December 31, 2004.

13. Derivative Financial Instruments

The Company utilizes interest rate swap derivatives to manage changes in market conditions related to interest rate payments on its variable rate debt obligations. These swap agreements provide for the exchange of variable rate payments for fixed rate payments without the exchange of the underlying notional amounts by agreeing to pay an amount equal to a specified fixed rate of interest times the notional principal amount and to receive in turn an amount equal to a specified variable rate of interest times the same notional amount.

As of December 31, 2005 and 2004, the Company had interest rate swap agreements with total notional amounts of \$110,000 and \$85,000, respectively, with maturity dates ranging from November 2006 to December 2009. The Company recognizes all derivatives on the balance sheet at fair value. Changes in the fair value for the effective portion of the gain or loss on a derivative that is designated as, and meets all the required criteria for, a cash flow hedge are recorded in Accumulated Other Comprehensive Income (Loss) and reclassified into earnings

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as the underlying hedged items affect earnings. Amounts reclassified into earnings related to interest rate swap agreements are included in interest expense. The ineffective portion of the gain or loss on a derivative is recognized in earnings within other income or expense. The fair value of the derivatives was recorded as a long-term asset of \$1,079 at December 31, 2005 and an other long-term liability of \$290 at December 31, 2004. Unrealized net gains of \$1,079 (\$631 net of tax) at December 31, 2005 and unrealized net losses of \$290 (\$172 net of tax) at December 31, 2004 related to these interest rate swaps were included in Accumulated Other Comprehensive Income (Loss). No hedge ineffectiveness has been recorded for existing derivative instruments based on calculations in accordance with SFAS No. 133, as amended.

14. Commitments and Contingencies

D&E leases buildings and other property under various operating lease agreements that expire between 2006 and 2023. Future minimum lease payments under operating leases are as follows:

Year	Amount
2006	\$ 666
2007	189
2008	118
2009	52
2010	18
Thereafter	96

Total rent expense for the years ended December 31 was approximately \$2,722 in 2005, \$2,642 in 2004 and \$2,882 in 2003.

D&E has agreements for compensation payments due to former officers, employees and existing employees. These agreements require future annual payments as listed below. Interest is imputed at 6.5%.

Year	Amount
2006	\$ 861
2007	74
2008	590
2009	57
2010	57
Thereafter	143

D&E has obligations under a Build-to-Suit agreement ("BTS") with Mountain Union Telecom LLC ("Mountain Union"). The obligations related to the construction of 20 wireless tower sites for Conestoga's wireless subsidiary, Conestoga Wireless Company ("CWC"). In November 2002, D&E entered into an asset purchase agreement with Keystone Wireless LLC ("Keystone Wireless") for the sale of the assets of CWC. Although D&E sold the assets of this business, its obligations under the BTS were not assumed by Keystone Wireless. Under the BTS, D&E is obligated to work with Mountain Union to find and develop 20 wireless tower sites and after construction of each site, enter into a long-term operating lease with Mountain Union for the site. Keystone is also contractually obligated to assume any operating leases entered into under the BTS. In accordance with the terms of the BTS agreement, D&E paid Mountain Union \$700 in October 2003 and \$200 in July 2004 for nonperformance penalties due for nine wireless tower sites that will not be constructed. Under the terms of the asset purchase agreement, Keystone will reimburse D&E for one-half of the penalties paid not to exceed \$125. Because the underlying assets of CWC were sold under the asset purchase agreement, D&E has

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considered any remaining obligations and potential penalties under the BTS a contingent liability. As of December 31, 2005, D&E has recorded a \$200 liability for its remaining commitment under the BTS.

As part of the Company's acquisition of Conestoga, D&E assumed a guarantee agreement with Mountain Union for lease obligations on the wireless tower sites of Conestoga's wireless subsidiary. When D&E entered into the asset purchase agreement with Keystone Wireless, whereby Keystone Wireless was assigned the responsibility for the leases, Mountain Union declined to release D&E from its guarantee. In the event of a default by Keystone Wireless, D&E continues to guarantee the wireless tower site lease payments, which cover a 10-year period beginning on the commencement date of the lease of each tower. As such, the guarantee is a continuing guarantee provided on an individual tower site basis. The lease payments start at \$1.5 per site per month, with provision for an increase of 4% per year. The maximum potential amount of undiscounted future payments that D&E could be required to make under the guarantee as of December 31, 2005 is \$11,439. The majority of these tower site leases and our guarantee will expire between 2011 and 2013. As of December 31, 2005, D&E has recorded a liability for the lease guarantees of \$3,200. In the event that D&E is required to pay in excess of \$100 to Mountain Union under D&E's guarantee of the wireless tower site lease payments, then at such time, a default would occur on Keystone Wireless' \$10,000 note payable to D&E, received in connection with the sale of the assets of CWC. Upon such default, the entire remaining balance of the \$10,000 note, which is currently \$8,375, would be immediately due and payable, and D&E could exercise its rights and remedies as the holder of a second lien security interest in all of the assets of Keystone Wireless. D&E will recognize release from risk for the guarantee upon expiration or settlement of the guarantee.

D&E has committed to loan EuroTel, on an equal basis with the other investors in EuroTel, certain of its operating cash needs. D&E expects that its 2006 funding requirements for EuroTel will be approximately \$750. Additionally, D&E is required under Pennsylvania PUC Chapter 30 regulations to make broadband services available to all of its RLEC customers by December 31, 2008. The Company is currently capable of providing broadband services as defined by the law to 98% of its RLEC customers and anticipate that the additional capital expenditures required to satisfy that commitment will be less than \$1,000.

15. Income Taxes

The provision for income taxes consists of the following:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Current:			
Federal	\$ 9,202	\$ 2,990	\$ 448
State	360	332	1,083
	<u>9,562</u>	<u>3,322</u>	<u>1,531</u>
Deferred:			
Federal	(2,540)	(938)	1,050
State	(1,216)	(954)	(640)
	<u>(3,756)</u>	<u>(1,892)</u>	<u>410</u>
Total income taxes	5,806	1,430	1,941
Tax benefit from discontinued operations	—	—	27
Income taxes from continuing operations	<u>\$ 5,806</u>	<u>\$ 1,430</u>	<u>\$ 1,968</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The effective income tax rate on consolidated pre-tax earnings from continuing operations differs from the federal income tax statutory rate for the following reasons:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Federal statutory rate	35.0%	34.0%	34.0%
Increase (decrease) resulting from:			
State income taxes, net of federal tax benefits	(2.8)	32.9	1.3
Valuation allowance	(11.2)	(176.3)	—
Effect of change in deferred income tax rate	9.7	—	—
Prior-period tax	—	(6.9)	(3.2)
Other, net	<u>(1.1)</u>	<u>1.3</u>	<u>1.2</u>
Effective income tax rate	<u>29.6%</u>	<u>(115.0)%</u>	<u>33.3%</u>

The significant components of the net deferred income tax liability were as follows at December 31:

	<u>2005</u>	<u>2004</u>
Deferred tax liabilities:		
Depreciation	\$ 23,143	\$ 27,064
Intangible assets	66,984	70,114
Investments	<u>376</u>	<u>45</u>
	90,503	97,223
Deferred tax assets:		
Employee benefits	6,221	4,576
Net operating loss carryforwards	13,969	13,137
Equity in net loss of affiliates	—	2,193
Other, net	<u>5,437</u>	<u>6,992</u>
	25,627	26,898
Valuation allowance	<u>(13,969)</u>	<u>(14,752)</u>
Net deferred tax assets (liabilities)	<u><u>\$ (78,845)</u></u>	<u><u>\$ (85,077)</u></u>

The components of the net deferred tax balances are as follows:

	<u>2005</u>	<u>2004</u>
Deferred income tax asset—current	\$ 218	\$ 1,325
Deferred income tax liability—non-current	<u>(79,063)</u>	<u>(86,402)</u>
Net deferred income tax assets (liabilities)	<u><u>\$ (78,845)</u></u>	<u><u>\$ (85,077)</u></u>

The net deferred taxes reported in the Consolidated Balance Sheet are as follows:

	<u>2005</u>	<u>2004</u>
Current assets—other	\$ 218	\$ 1,325
Other liabilities—deferred income taxes	<u>(79,063)</u>	<u>(86,402)</u>

Approximately \$215,121 of state net operating loss carryforwards remained at December 31, 2005. These carryforwards are due to the operations of D&E's subsidiaries and will expire in the years 2006 through 2025.

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The benefit of these carryforwards is dependent on the taxable income of these subsidiaries during the carryforward period.

The Company has established a combined valuation allowance of \$13,969 due to the uncertainty regarding the ability to utilize state net operating loss carryforwards. The amount of the deferred tax asset valuation could change if estimates of future taxable income during the carryforward period are revised.

16. Shareholders' Equity

D&E has an Employee Stock Purchase Plan ("ESPP"), which provides D&E's eligible employees the opportunity to purchase shares of D&E's common stock through payroll deductions. There are 437,655 shares of common stock reserved for issuance pursuant to the ESPP at December 31, 2005. The total number of shares purchased pursuant to the ESPP during 2005, 2004 and 2003 was 23,513, 24,827 and 25,891, respectively. Through December 31, 2005, shares for the ESPP could be purchased at a 10% discount from fair market value. Beginning in 2006, ESPP shares may be purchased at a 5% discount from fair market value. If no shares were traded on the day of purchase, then the prices on the previous day are used to compute the per-share price.

D&E offers a Dividend Reinvestment and Stock Purchase Plan ("DRP") to D&E's shareholders. The DRP provides all shareholders of D&E's common stock the opportunity to purchase additional shares of common stock by: 1) reinvesting all cash dividends paid on their shares of common stock; 2) making optional cash purchases of common stock, up to a maximum amount per quarter, while continuing to receive cash dividends; or 3) both reinvesting all cash dividends and making such optional cash purchases. There are 27,112 shares of common stock reserved for issuance pursuant to the DRP at December 31, 2005. The total number of shares purchased through the DRP during 2005, 2004 and 2003 was 42,296, 27,534 and 33,506, respectively. Shares for the DRP are purchased by participants at fair market value, which is defined as the average of the highest and lowest per-share sale prices as reported by the NASDAQ National Market on the day of the purchase.

D&E has a Stock Compensation Plan and Policy for Non-Employee Directors. Certain non-employee directors receive common stock in payment for their services as a director of the company. There are 2,424 shares of common stock reserved for issuance pursuant to the plan at December 31, 2005. The total number of shares issued under this plan during 2005, 2004 and 2003 was 6,936, 2,000 and 1,300, respectively.

There are 371,121 shares of D&E's common stock reserved for issuance under the 1999 Long-Term Incentive Plan (LTIP) at December 31, 2005. In 2005, there were 10,000 fully vested stock options granted and 2,297 fully vested shares of common stock issued. There were no shares issued or stock options granted in 2004 and 2003. There are also 655,737 shares of common stock reserved for issuance under the Conestoga Stock Option Plan at December 31, 2005. There were no stock options granted under the Conestoga plan in 2005, 2004 or 2003.

On August 22, 2005, the trustees of the D&E Communications, Inc. Voting Trust elected to terminate the voting trust. The voting trust included approximately 2.2 million shares from 59 participants, or approximately 15% of the outstanding common stock of D&E. The stock of D&E held by the voting trust has been returned to the participating shareholders, free of trust, and each participant may now exercise individual voting rights for their respective shares. At December 31, 2004, shares of D&E's common stock of 2,160,610, were held in the voting trust. Certain D&E officers and directors were trustees of the voting trust.

On August 13, 2004, D&E purchased 1,333,500 shares of its common stock at a total purchase price of \$13,335 from Citizens Communication Company, or approximately 8.56% of the outstanding common stock of D&E. The negotiated repurchase also terminated a 1997 Stock Acquisition Agreement pursuant to which an

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affiliate of Citizens originally acquired 1,300,000 shares of D&E common stock in consideration for \$27,015. Under that agreement, Citizens was required, among other things, to provide D&E with an opportunity to purchase the shares prior to selling those shares generally. There were no treasury stock purchases in 2005 and 2003.

17. Stock Option Plan

The Company has stock options outstanding under the 1999 Long-Term Incentive Plan and the Conestoga Enterprises, Inc. 1999 Stock Option Plan. The per share exercise price of a stock option shall be not less than the fair market value of the underlying common stock on the date the option is granted. There was a combined total of 1,026,858 options available for grant at December 31, 2005.

On December 21, 2005, the Executive Committee of the D&E Board of Directors approved the accelerated vesting of certain employee stock options that were granted under the 1999 Long-Term Incentive Plan of D&E Communications, Inc. or the Conestoga Enterprises, Inc. 1999 Stock Option Plan, which would have been unvested as of December 31, 2005 and had exercise prices greater than the closing price at December 20, 2005 of \$8.41 per share. As a result of this acceleration of the vesting, options to purchase 22,041 shares of D&E's common stock became exercisable immediately. The number of shares, exercise prices and other terms of the options subject to the acceleration remain unchanged. The decision to accelerate the vesting of these options was made to reduce non-cash compensation expense that would have been recorded in D&E's income statement in future periods upon the adoption of SFAS No. 123R, "Share-Based Payment," in January 2006.

A summary of the stock option activity and related information for the years ended December 31 follows:

	2005		2004		2003	
	Options	Average Weighted Exercise Price	Options	Average Weighted Exercise Price	Options	Average Weighted Exercise Price
Outstanding options at beginning of year	221,358	\$ 10.01	256,915	\$ 10.20	328,432	\$ 9.97
Granted	10,000	9.92	—	—	—	—
Exercised	(2,000)	8.24	—	—	(71,517)	9.14
Cancelled	(7,953)	9.00	(35,557)	11.39	—	—
Outstanding options at end of year	<u>221,405</u>	\$ 10.06	<u>221,358</u>	\$ 10.01	<u>256,915</u>	\$ 10.20

The following table presents summarized information about stock options outstanding at December 31, 2005:

Range of Exercise Prices	Options Outstanding At December 31, 2005	Weighted Average Exercise Price	Weighted Average Contractual Remaining Life	Options Exercisable at December 31, 2005	Weighted Average Exercise Price
\$8.24-\$14.50	221,405	\$10.06	5.1 years	221,405	\$10.06

D&E applies APB Opinion 25 and related interpretations in accounting for the stock option plan. All options are issued with an exercise price equal to the fair market value of the stock at the date of grant; accordingly, no compensation cost has been recognized. See Note 2, Stock-Based Compensation, for the pro forma effect of applying the fair value provisions of SFAS 123.

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18. Employee Benefit Plans**Employees' Retirement Plan and Postretirement Health Care Benefits**

D&E's pension plans are noncontributory defined benefit plans computed on an actuarial basis covering all eligible employees. Pension benefits are based upon length of service and the employee's average pensionable compensation as defined by the plans. Accrued benefits are vested after five years of participation in the plan. The Company sponsors two pension plans: the D&E Communications, Inc. Employees' Retirement Plan and the Conestoga Telephone & Telegraph Company Pension Plan for Members of Local 1671.

D&E also provides certain basic health care benefits to eligible individuals who retired under the D&E Communications, Inc. Employees' Retirement Plan between the period of December 31, 1972, and July 1, 1992. Through December 31, 2005, those benefits were provided by the Employee Benefit Plan Trust, a self-insured plan, and by individual policies from an insurance company. Beginning January 1, 2006, all applicable benefits will be provided by individual policies from an insurance company. Effective July 1992, retiree health care benefits were discontinued for active employees participating in the D&E Communications, Inc. Employees' Retirement Plan.

D&E provides an opportunity for grandfathered retiring members of the former Pension Plan for Employees of Buffalo Valley and the Conestoga Telephone & Telegraph Company Pension Plan for Members of Local 1671 to purchase health care benefits under the Company's fully-insured plan. Members of these Plans who elect to continue their coverage at retirement pay 100% of the applicable premiums. D&E also provides an opportunity for grandfathered retiring members of the former Conestoga Telephone & Telegraph Company Pension Plan to purchase health care benefits under the Company's fully-insured plan. The Company pays 50% of the premium for members of this Plan who elect to continue coverage at retirement. On July 21, 2004 the Company decided to discontinue offering these benefits for non-union grandfathered employees who were not eligible to retire with an unreduced pension benefit by June 30, 2005.

On July 12, 2005, the Company decided to discontinue offering postretirement medical and prescription drug benefits for Conestoga union employees who were not eligible to retire with an unreduced pension benefit by June 1, 2005. As a result of this amendment to the postretirement plan, the Company's accumulated postretirement benefit obligation decreased by approximately \$260, and the annual postretirement benefits expense decreased by \$30 in 2005. The full year savings expected in 2006 and later years is approximately \$60.

The applicable annual accruals represent the estimated cost of providing these benefits to current and future retirees and is determined on an actuarial basis.

The accrued postretirement benefit liability of \$2,769 is included in other current and long-term liabilities in the accompanying consolidated balance sheets.

In December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 ("The Act") was enacted into law. The Act provides a voluntary prescription drug benefit under Medicare as well as a federal subsidy to sponsors of retiree health care plans that provide at least an actuarially equivalent benefit. In May 2004, the FASB issued Staff Position No. FSP FAS 106-2, "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" ("FAS 106-2"). FAS 106-2 provides guidance on accounting for the effects of the new Medicare prescription drug benefit and the related federal subsidy available to employers whose prescription drug benefits are at least actuarially equivalent to the drug benefit provided under Medicare Part D.

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In response to The Act, D&E determined in August 2005 that the individual prescription drug options that will be available to Medicare beneficiaries through Part D will provide more flexibility, cost savings and greater choices than what is available through D&E's benefit programs. As a result, effective January 1, 2006, D&E discontinued offering prescription drug programs to Medicare eligible retiree groups and, for certain groups of nonunion retirees, will reimburse an amount towards the annual premium cost of an individual prescription drug program chosen by the retiree. As a result of this amendment, the Company's accumulated postretirement benefit obligation decreased by approximately \$669, and the annual postretirement benefit expense decreased by approximately \$100 in 2005. Because of the plan change, D&E is no longer eligible for federal subsidies under The Act.

The obligations and funded status of the plans are as follows:

	Pension Benefits		Postretirement Benefits	
	2005	2004	2005	2004
Change in Benefit Obligation:				
Projected benefit obligation at beginning of year	\$65,390	\$56,920	\$4,021	\$ 4,667
Service cost	2,561	2,265	20	112
Interest cost	3,603	3,526	178	268
Actuarial loss	(804)	2,109	(310)	284
Changes in assumptions	182	4,505	—	233
Amendments	—	(888)	(934)	(1,310)
Benefits paid	(3,337)	(3,047)	(235)	(233)
Projected benefit obligation at end of year	<u>\$67,595</u>	<u>\$65,390</u>	<u>\$2,740</u>	<u>\$ 4,021</u>
	Pension Benefits		Postretirement Benefits	
	2005	2004	2005	2004
Change in Plan Assets:				
Fair value of assets at beginning of year	\$43,546	\$41,801	\$ 495	\$ 579
Actual return on plan assets	2,666	2,629	21	19
Employer contributions	2,944	2,163	129	102
Benefits paid	(3,337)	(3,047)	(210)	(205)
Other	(123)	—	—	—
Fair value of assets at end of year	<u>\$45,696</u>	<u>\$43,546</u>	<u>\$ 435</u>	<u>\$ 495</u>

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
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	Pension Benefits		Postretirement Benefits	
	2005	2004	2005	2004
Recognition of Funded Status of the Plan:				
Funded status at end of year	\$(21,899)	\$(21,844)	\$(2,305)	\$(3,526)
Unrecognized net actuarial loss	18,827	20,103	1,534	1,925
Unrecognized prior service cost	(619)	(687)	(1,998)	(1,268)
Unrecognized initial obligation	—	—	—	83
Net amount recognized at end of year	<u>\$ (3,691)</u>	<u>\$ (2,428)</u>	<u>\$(2,769)</u>	<u>\$(2,786)</u>
Amounts Recognized in the Financial Statements Consist of:				
Prepaid benefit cost	\$ —	\$ 937	\$ —	\$ 17
Accrued benefit cost	(14,338)	(14,141)	(2,769)	(2,803)
Intangible assets	—	—	—	—
Accumulated other comprehensive income	10,647	10,776	—	—
Net amount recognized at end of year	<u>\$ (3,691)</u>	<u>\$ (2,428)</u>	<u>\$(2,769)</u>	<u>\$(2,786)</u>

The accumulated benefit obligation for all defined benefit pension plans was \$60,035 and \$56,949 at December 31, 2005 and 2004, respectively.

Information for pension plans with an accumulated benefit obligation in excess of plan assets follows:

	2005	2004
Projected benefit obligation	\$67,595	\$54,383
Accumulated benefit obligation	60,035	48,144
Fair value of plan assets	45,696	34,003

The costs for the Company's pension plans and postretirement benefits other than pensions consisted of the following components:

	Pension Benefits			Postretirement Benefits		
	2005	2004	2003	2005	2004	2003
Components of Net Periodic Benefit Cost:						
Service cost	\$ 2,561	\$ 2,265	\$ 2,086	\$ 20	\$112	\$141
Interest cost	3,603	3,526	3,352	178	268	270
Expected loss (return) on assets	(3,333)	(3,476)	(3,398)	(34)	(41)	(42)
Amortization of:						
Initial obligation	—	—	—	16	21	89
Prior service cost	(68)	(68)	15	(121)	(42)	—
Actuarial loss	1,445	1,024	700	78	86	13
Total net periodic benefit cost	<u>\$ 4,208</u>	<u>\$ 3,271</u>	<u>\$ 2,755</u>	<u>\$ 137</u>	<u>\$404</u>	<u>\$471</u>

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Additional information regarding the minimum pension liability follows:

	<u>Pension Benefits</u>		<u>Postretirement Benefits</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Increase (decrease) in minimum pension liability included in other comprehensive income	\$(129)	\$4,620	N/A	N/A

The decrease in minimum pension liability between December 31, 2004 and December 31, 2005 was attributed mainly to favorable plan asset returns.

Key pension and postretirement assumptions

The Company reviews the appropriateness of the assumptions used to develop the pension and postretirement obligations on a regular basis. Management develops each assumption using relevant company experience and market-related data to ensure that each assumption is individually reasonable. For example, the company enlists the services of its plan actuaries, who have developed an interest rate yield curve to assist their clients in evaluating discount rates. Under this approach, the Company's projected benefit cash flows are analyzed using this yield curve to develop a single-point discount rate matching the plans characteristics. Similarly, the Company determines its expected return on plan assets assumption by evaluating both historical returns, as well as estimates of future returns.

Based on the approaches outlined above, the Company lowered its rates of compensation increase assumption from 4.50% to 4.00% and its discount rate assumption for other benefits from 5.75% to 5.50% at December 31, 2005. In addition, a new mortality table, RP 2000 projected to 2006, was adopted by the Company as of December 31, 2005.

The weighted average assumptions used to determine benefit obligations at December 31 follow:

	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Discount rate	5.75%	5.75%	5.50%	5.75%
Rates of compensation increase	4.00%	4.50%	N/A	N/A

The weighted-average assumptions used to determine net cost for the years ended December 31 follow:

	<u>Pension Benefits</u>		<u>Other Benefits</u>	
	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
Discount rate	5.75%	6.25%	5.75%	6.25%
Expected long-term return on plan assets	8.50%	8.75%	8.75%	8.75%
Rate of compensation increase	4.50%	4.50%	N/A	N/A

The assumed health care cost trend rates at December 31 follow:

	<u>2005</u>	<u>2004</u>
Health care cost trend rate assumed for next year	9.00%-12.00%	10.00%
Rate to which the cost trend rate is assumed to decline	4.75%	4.50%
Year that the rate reaches the ultimate trend rate	2011-2013	2011

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

	<u>1-Percentage Point Increase</u>	<u>1-Percentage Point Decrease</u>
Effect on total of service and interest cost	\$ 15	\$ (14)
Effect on postretirement benefit obligation	216	(191)

Plan Assets

D&E's retirement plan investment strategy is to invest approximately 65% of the plan assets in the equity market and 35% in the fixed income market. The investment advisor reviews the investment performance with the Benefits Committee several times per year, and investment reallocations or other changes are made when appropriate.

The Company's pension plan weighted-average asset allocations at December 31, 2005 and 2004, by asset category are as follows:

	<u>2005</u>	<u>2004</u>
Asset Category:		
Equity securities	65%	65%
Debt securities	35%	35%
Total	<u>100%</u>	<u>100%</u>

The Company's other postretirement benefit plan weighted-average asset allocations at December 31, 2005 and 2004, by asset category are as follows:

	<u>2005</u>	<u>2004</u>
Asset Category:		
Equity securities	51%	51%
Debt securities	49%	49%
Total	<u>100%</u>	<u>100%</u>

D&E expects to contribute \$3,500 to its pension plan and \$0 to its other postretirement benefit plan in 2006.

The estimated future benefit payments are as follows:

<u>Year</u>	<u>Pension Benefits</u>	<u>Other Benefits</u>
2006	\$ 2,857	\$ 205
2007	2,895	227
2008	3,070	242
2009	3,270	258
2010	3,441	270
2011 to 2015	21,216	1,236

Employees' 401(k) Savings Plan

D&E has two employee savings plans available to all eligible employees: the D&E Communications, Inc. Employees' 401(k) Savings Plan and the Conestoga Telephone & Telegraph Co. Local 1671 Tax Deferred

Table of Contents**D&E COMMUNICATIONS, INC. AND SUBSIDIARIES**
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Retirement Plan. Participating employees may contribute a portion of their compensation, up to a maximum percentage, to the Savings Plans, and the Company makes matching contributions based upon the eligible employee's contribution. D&E may also make discretionary profit-sharing contributions.

Company contributions amounted to \$1,204 in 2005, \$1,275 in 2004 and \$1,099 in 2003.

1999 Long-Term Incentive Plan

The 1999 Long-Term Incentive Plan (the Plan) was approved by the shareholders of the Company during 1999. Officers and other key employees of the Company are eligible for participation in the Plan. Awards under the Plan are made at the discretion of the Board of Directors and/or the Board's Compensation Committee. There were 525,000 shares registered for issuance under the Plan.

In 2005, there were 47,400 performance-restricted shares of common stock awarded to participants in the Plan and 2,667 shares forfeited due to a participant retirement. There were no grants of performance-restricted shares in 2004 and 2003. A performance restricted share of common stock entitles a participant to receive a target number of shares of common stock after a minimum vesting period based upon the Company's attainment of a predetermined goal during a specified performance period. If the minimum goals are not met, no performance-restricted shares will be earned by the participant. If the performance goals are fully achieved, 100% of the performance-restricted shares will be earned by the participant. During the performance period, each performance-restricted share is considered equal to one share of common stock for dividend (but not voting) purposes, and the participant is entitled to dividend equivalents, which are reinvested in additional performance-restricted shares. At the end of the vesting period, any performance-restricted shares that have been earned will be converted to shares of common stock through the issuance of shares. D&E accrues compensation cost related to these performance-restricted shares based upon the probability that the conditions to receive these shares are met.

In 2005, there were 2,297 fully-vested shares of common stock issued to employees of the Company under the Plan.

The cost of the Plan amounted to \$175 in 2005. There were no costs of the Plan in 2004 and 2003.

19. Disclosures about Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

a. *Cash and temporary cash investments* — The carrying amount approximates fair value because of the short maturity of these instruments.

b. *Investments* — Investments consist primarily of investments in and advances to affiliated companies accounted for under the equity method for which disclosure of fair value is not required.

c. *Debt* — The fair value of fixed rate long-term debt was estimated based on our current incremental borrowing rate for debt of the similar remaining maturities. The fair value of floating rate debt approximates carrying value since the debt has been repriced no less frequently than every three months during 2005 and 2004.

d. *Interest rate swaps* — The fair value has been calculated by the counterparties using appropriate valuation methodologies.

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The estimated fair value of our financial instruments is as follows:

	December 31,			
	2005		2004	
	<u>Carrying Value</u>	<u>Fair Value</u>	<u>Carrying Value</u>	<u>Fair Value</u>
Financial assets:				
Cash & cash equivalents	\$ 10,325	\$ 10,325	\$ 8,517	\$ 8,517
Financial liabilities:				
Fixed rate long-term debt:				
Secured term loans	31,500	35,045	35,000	41,583
Variable rate long-term debt:				
Revolving Loan	7,000	7,000	10,000	10,000
Term Loan A	31,561	31,561	36,561	36,561
Term Loan B	145,439	145,439	146,939	146,939
Interest rate swaps	1,079	1,079	(290)	(290)

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

20. Segment Reporting

D&E's business segments are as follows: incumbent rural local exchange carrier (RLEC), competitive local exchange carrier (CLEC), internet services and systems integration. Conestoga Wireless results previously reported as a separate segment are included with the Corporate and Other amounts. The segments are more fully described in Note 1. Certain amounts from prior years have been reclassified to conform to the current presentation. For more information on significant noncash items, see Note 3. Intersegment revenues are recorded at the same rates charged to external customers.

	RLEC	CLEC	Internet Services	Systems Integration	Corporate & Other	Eliminations	Total Company
2005							
External customer revenues	\$100,934	\$38,291	\$12,999	\$ 20,241	\$ 3,782	\$ —	\$176,247
Intersegment revenues	9,517	2,505	40	28	—	(12,090)	—
Depreciation & amortization	29,524	5,052	1,378	1,624	1,167	—	38,745
Operating income (loss)	32,532	(1,511)	(642)	(5,790)	(1,930)	—	22,659
Equity in net income of affiliates	—	—	—	—	1,000	—	1,000
Gain (loss) on investments	—	—	—	—	6,895	—	6,895
Segment assets	435,193	67,472	3,724	16,792	461,931	(449,440)	535,672
Equity in net losses of affiliates in excess of investments	—	—	—	—	(196)	—	(196)
Capital expenditures	23,410	4,331	1,931	447	532	—	30,651
2004							
External customer revenues	\$101,647	\$36,183	\$10,337	\$ 24,771	\$ 3,333	\$ —	\$176,271
Intersegment revenues	9,314	1,409	21	54	—	(10,798)	—
Depreciation & amortization	30,776	4,394	1,083	1,899	967	—	39,119
Operating income (loss)	29,162	(2,695)	327	(4,580)	(1,267)	—	20,947
Equity in net loss of affiliates	—	—	—	—	(3,172)	—	(3,172)
Gain (loss) on investments	—	—	—	—	(1,057)	—	(1,057)
Segment assets	446,277	67,128	3,009	19,064	447,663	(436,356)	546,785
Investment in equity method affiliates	—	—	—	—	52	—	52
Capital expenditures	18,910	5,041	1,073	1,065	922	—	27,011
2003							
External customer revenues	\$105,087	\$34,830	\$ 6,862	\$ 23,378	\$ 2,968	\$ —	\$173,125
Intersegment revenues	8,207	923	479	31	22	(9,662)	—
Depreciation & amortization	31,591	4,036	794	1,734	471	—	38,626
Operating income (loss)	33,663	(3,837)	(109)	(4,322)	(1,628)	—	23,767
Equity in net loss of affiliates	—	—	—	—	(2,537)	—	(2,537)
Gain (loss) on investments	—	—	—	—	790	—	790
Segment assets	458,319	64,559	3,086	20,932	451,517	(422,502)	575,911
Investment in equity method affiliates	—	—	—	—	3,611	—	3,611
Capital expenditures	13,900	4,014	1,300	914	1,704	—	21,832

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table shows a reconciliation of the results for the business segments to the applicable line items in the consolidated financial statements as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Operating income from reportable segments	\$ 24,589	\$ 22,214	\$ 25,395
Corporate and other	(1,930)	(1,267)	(1,628)
Equity in net income (losses) of affiliates	1,000	(3,172)	(2,537)
Interest expense	(14,177)	(14,389)	(18,074)
Gain (loss) on investments	6,895	(1,057)	790
Loss on early extinguishment of debt	—	(5,252)	—
Other, net	<u>3,205</u>	<u>1,679</u>	<u>1,964</u>
Income (loss) from continuing operations before income taxes and dividends on utility preferred stock	<u>\$ 19,582</u>	<u>\$ (1,244)</u>	<u>\$ 5,910</u>

21. Quarterly Results of Operations (unaudited)

The following table summarizes D&E's quarterly financial data for the years ended December 31, 2005 and December 31, 2004.

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
	(In thousands, except per share data)			
2005				
Total operating revenues	\$42,839	\$44,042	\$44,288	\$45,078
Depreciation and amortization	9,650	9,731	9,814	9,550
Other operating expenses	<u>28,572</u>	<u>29,487</u>	<u>28,476</u>	<u>28,308</u>
Total operating expenses	<u>38,222</u>	<u>39,218</u>	<u>38,290</u>	<u>37,858</u>
Operating income	4,617	4,824	5,998	7,220
Income before cumulative effect of change in accounting principle	2,888	1,367	2,392	7,064
Net income	2,888	1,367	2,392	7,064
Earnings per common share — basic and diluted:				
Income before cumulative effect of change in accounting principle	\$ 0.20	\$ 0.10	\$ 0.17	\$ 0.49
Net income	0.20	0.10	0.17	0.49
2004				
Total operating revenues	\$43,765	\$44,135	\$43,692	\$44,679
Depreciation and amortization	9,701	9,918	9,724	9,776
Other operating expenses	<u>29,050</u>	<u>29,026</u>	<u>29,508</u>	<u>28,621</u>
Total operating expenses	<u>38,751</u>	<u>38,944</u>	<u>39,232</u>	<u>38,397</u>
Operating income	5,014	5,191	4,460	6,282
Income (loss) before cumulative effect of change in accounting principle	(2,256)	1,233	719	(2,435)
Net income (loss)	(2,256)	1,233	719	(2,435)
Earnings (loss) per common share — basic and diluted:				
Income (loss) before cumulative effect of change in accounting principle	\$ (0.15)	\$ 0.08	\$ 0.05	\$ (0.17)
Net income (loss)	(0.15)	0.08	0.05	(0.17)

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D&E COMMUNICATIONS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Significant quarterly variances of net income (loss) are explained below:

The net income in the first quarter of 2005 included a \$2,043 (\$1,349, or \$0.09 per common share, after tax) gain on the sale of D&E's investment in PenTeleData.

The increase in net income in the third quarter 2005 compared to the second quarter of 2005 was primarily due to decreases in employee wages and benefits.

The net income in the fourth quarter of 2005 included \$6,415 (\$5,969, or \$0.42 per common share after tax) income from the sale of D&E's direct and indirect interests in Pilicka on December 19, 2005.

The net loss in the first quarter of 2004 included \$4,841 (\$2,871, or \$0.18 per common share after tax) loss on early extinguishment of debt related to a syndicated senior debt financing completed on March 5, 2004.

The net loss in the fourth quarter of 2004 included \$2,125 (\$2,125, or \$0.14 per common share after tax) loss for D&E's share of an impairment of assets at Pilicka and an impairment of our investment in EuroTel.

The following tables summarizes D&E's operating results for the three months ended December 31, 2005:

	<u>RLEC</u>	<u>CLEC</u>	<u>Internet Services</u>	<u>Systems Integration</u>	<u>Corporate & Other</u>	<u>Eliminations</u>	<u>Total Company</u>
External customer revenues	\$25,940	\$ 9,866	\$3,456	\$ 4,608	\$ 1,208	\$ —	\$45,078
Intersegment revenues	2,503	672	19	7	—	(3,201)	—
Total revenues	28,443	10,538	3,475	4,615	1,208	(3,201)	45,078
Depreciation and amortization	7,103	1,417	357	364	309	—	9,550
Other operating expenses	11,924	9,439	3,074	5,726	1,346	(3,201)	28,308
Total operating expenses	19,027	10,856	3,431	6,090	1,655	(3,201)	37,858
Operating income (loss)	<u>\$ 9,416</u>	<u>\$ (318)</u>	<u>\$ 44</u>	<u>\$ (1,475)</u>	<u>\$ (447)</u>	<u>\$ —</u>	<u>\$ 7,220</u>

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D&E COMMUNICATIONS, INC.

SCHEDULE II — VALUATION AND QUALIFYING ACCOUNTS

	Balance at Beginning of Year	Additions Charged to Cost and Expenses	Deductions Credited to Costs and Expenses	Balance at End of Year
Allowance for doubtful accounts:				
Year ended December 31, 2005	\$ 1,024	\$ 485	\$ 761	\$ 748
Year ended December 31, 2004	1,410	551	937	1,024
Year ended December 31, 2003	1,416	745	751	1,410
Allowance for inventory obsolescence:				
Year ended December 31, 2005	115	181	296	—
Year ended December 31, 2004	—	288	173	115
Year ended December 31, 2003	—	—	—	—
Valuation Allowance for Deferred Tax Assets:				
Year ended December 31, 2005	14,752	1,428	2,211	13,969
Year ended December 31, 2004	11,132	3,715	95	14,752
Year ended December 31, 2003	11,969	—	837	11,132

All other schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

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**EUROTEL, L.L.C.
LINCOLN, NEBRASKA**

CONSOLIDATED FINANCIAL STATEMENTS WITH INDEPENDENT AUDITORS' REPORTS
As of December 31, 2004 and 2003 and for each of the three years in the period ended December 31, 2004

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LINCOLN, NEBRASKA

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Table of Contents**INDEPENDENT AUDITORS' REPORT**

To the Members of
EuroTel, L.L.C.
Lincoln, Nebraska

We have audited the accompanying consolidated balance sheets of EuroTel, L.L.C. (a Nebraska limited liability company) and subsidiary as of December 31, 2004 and 2003, and the related consolidated statements of operations, members' equity, and cash flows for each of the three years in the period ended December 31, 2004. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We did not audit the December 31, 2004, 2003 and 2002 financial statements of Pilicka Telefonía Sp. z.o.o., (Pilicka), a Polish company owned 27.85% by EuroTel L.L.C., the investment in which, as discussed in Note 5 of the consolidated financial statements, is accounted for by the equity method of accounting. The investment in Pilicka was \$0 and \$2,386,208 at December 31, 2004 and 2003, respectively, and the equity in its net losses were \$2,386,208, \$956,926, and \$966,704 for each of the three years in the period ended December 31, 2004. The financial statements of Pilicka were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it related to the amounts included for Pilicka, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as, evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of EuroTel, L.L.C. and subsidiary as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2, the Company is dependent upon the Founders to meet its cash flow requirements for the year 2005.

/s/ KIESLING ASSOCIATES LLP

Colorado Springs, Colorado
January 25, 2005, except for Note 5, for which the date
is March 1, 2005

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EUROTEL, L.L.C.
LINCOLN, NEBRASKA
CONSOLIDATED BALANCE SHEETS
December 31, 2004 and 2003

	<i>ASSETS</i>	<u>2004</u>	<u>2003</u>
CURRENT ASSETS			
Cash and cash equivalents		\$182,516	\$ 106,344
Accounts receivable		<u>16,037</u>	<u>17,311</u>
		<u>198,553</u>	<u>123,655</u>
NONCURRENT ASSETS			
Property, plant and equipment, net		1,403	—
Investment in affiliate		<u>—</u>	<u>2,386,208</u>
		<u>1,403</u>	<u>2,386,208</u>
TOTAL ASSETS		<u>\$199,956</u>	<u>\$2,509,863</u>

The accompanying notes are an integral part of these consolidated financial statements.

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EUROTEL, L.L.C.
LINCOLN, NEBRASKA
CONSOLIDATED BALANCE SHEETS
December 31, 2004 and 2003

	<u>2004</u>	<u>2003</u>
<i>LIABILITIES AND MEMBERS' EQUITY</i>		
CURRENT LIABILITIES		
Due to Founders	\$ 33,708,380	\$ 31,740,304
Accounts payable	44,886	70,464
	<u>33,753,266</u>	<u>31,810,768</u>
MEMBERS' EQUITY		
Members' capital	(33,553,310)	(29,127,157)
Cumulative other comprehensive loss	—	(173,748)
	<u>(33,553,310)</u>	<u>(29,300,905)</u>
TOTAL LIABILITIES AND MEMBERS' EQUITY	<u>\$ 199,956</u>	<u>\$ 2,509,863</u>

The accompanying notes are an integral part of these consolidated financial statements.

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EUROTEL, L.L.C.
LINCOLN, NEBRASKA
CONSOLIDATED STATEMENTS OF OPERATIONS
Years Ended December 31, 2004, 2003 and 2002

	2004	2003	2002
OPERATING REVENUES	\$ 0	\$ 0	\$ 0
OPERATING EXPENSES			
Depreciation and amortization	23	806	4,025
General and administrative	578,953	530,765	1,277,499
	<u>578,976</u>	<u>531,571</u>	<u>1,281,524</u>
OPERATING LOSS	<u>(578,976)</u>	<u>(531,571)</u>	<u>(1,281,524)</u>
OTHER INCOME (EXPENSE)			
Equity in loss of affiliate	(2,559,956)	(956,926)	(966,704)
Interest income	710	1,736	3,361
Litigation costs due to sale of affiliate	(1,287,932)	(1,702,006)	(2,173,178)
Loss on investment in affiliate	—	—	(726,833)
Loss on loan receivable	—	—	(596,849)
Other	—	(20,138)	23,101
	<u>(3,847,178)</u>	<u>(2,677,334)</u>	<u>(4,437,102)</u>
NET LOSS	<u>\$ (4,426,154)</u>	<u>\$ (3,208,905)</u>	<u>\$ (5,718,626)</u>

The accompanying notes are an integral part of these consolidated financial statements.

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EUROTEL, L.L.C.
LINCOLN, NEBRASKA
CONSOLIDATED STATEMENTS OF MEMBERS' EQUITY
Years Ended December 31, 2004, 2003 and 2002

	Members' Capital	Accumulated Other Comprehensive Income	Total Members' Equity (Deficit)	Annual Comprehensive Income (Loss)
Balance at December 31, 2001	\$(22,543,956)	\$ (2,033,392)	\$(24,577,348)	\$ 2,162,072
Net Loss	(5,718,626)		(5,718,626)	(5,718,626)
Capital Contributions	2,344,331		2,344,331	
Foreign currency translation adjustment		(173,748)	(173,748)	(173,748)
Transfer of foreign currency translation adjustment		2,033,392	2,033,392	
Balance at December 31, 2002	(25,918,252)	(173,748)	(26,092,000)	\$ (5,892,374)
Net Loss	(3,208,905)		(3,208,905)	(3,208,905)
Balance December 31, 2003	(29,127,157)	(173,748)	(29,300,905)	\$ (3,208,905)
Net Loss	(4,426,154)		(4,426,154)	(4,426,154)
Foreign currency translation adjustment		173,748	173,748	173,748
Balance at December 31, 2004	\$(33,553,310)	\$ —	(33,553,310)	\$ (4,252,406)

The accompanying notes are an integral part of these consolidated financial statements.

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EUROTEL, L.L.C.
LINCOLN, NEBRASKA
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2004, 2003 and 2002

	<u>2004</u>	<u>2003</u>	<u>2002</u>
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$(4,426,154)	\$(3,208,905)	\$(5,718,626)
Adjustment to reconcile net income (loss) to net cash provided by/			
(used in) operating activities:			
Loss on write-off of loan receivable	—	—	596,849
Depreciation and amortization	23	806	4,025
Loss on disposal of equipment	—	1,074	6,143
Equity in net losses of affiliate	2,559,956	956,926	966,704
Changes in assets and liabilities:			
(Increase) Decrease in:			
Receivables	(13,791)	—	(14,456)
Increase (Decrease) in:			
Accounts payable	(10,510)	(319)	(1,135,801)
Accounts payable to Founders	1,968,076	2,209,099	4,279,714
Accrued liabilities	—	—	(394,023)
Net cash provided by/(used in) operating activities	<u>77,600</u>	<u>(41,319)</u>	<u>(1,409,471)</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Investment in Pilicka	—	—	(1,100,000)
Cash transferred to Pilicka	—	—	(696,334)
Purchase of property, plant and equipment	(1,428)	—	—
Net cash used in investing activities	<u>(1,428)</u>	<u>—</u>	<u>(1,796,334)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from member contributions	—	—	2,344,331
Net cash provided by financing activities	<u>—</u>	<u>—</u>	<u>2,344,331</u>
Net Increase (Decrease) in Cash and Cash Equivalents	76,112	(41,319)	(861,474)
Cash and Cash Equivalents at Beginning of Year	106,344	147,663	1,009,137
Cash and Cash Equivalents at End of Year	<u>\$ 182,516</u>	<u>\$ 106,344</u>	<u>\$ 147,663</u>
Cash paid for interest	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 50,751</u>
Supplementary Disclosure of Noncash Activity:			
Transfer of assets and liabilities of Pilicka			
Current assets	\$ —	\$ —	\$ 1,729,662
Noncurrent assets	—	—	15,014,449
Current liabilities	—	—	(3,116,947)
Noncurrent liabilities	—	—	(1,356,890)
Cumulative translation adjustment	—	—	2,033,392
	<u>\$ —</u>	<u>\$ —</u>	<u>\$14,303,666</u>

See Notes 4 and 9 for other noncash activities.

The accompanying notes are an integral part of these consolidated financial statements.

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**EUROTEL, L.L.C.
LINCOLN, NEBRASKA
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2004, 2003 and 2002**

NOTE 1. ORGANIZATION

EuroTel L.L.C. (the Company) was organized in December 1993 to act as a holding company for a foreign investment in Pilicka Telefonía Sp. z o.o. (Pilicka). The Company directly held this investment until May 1998. In 1998, the Company organized a subsidiary, PenneCom B.V. (PenneCom), to act as a Dutch holding company for foreign investments. PenneCom is a wholly-owned subsidiary of the Company. In May 1998, Pilicka was contributed to PenneCom by the Company at its net book value, as the Company and PenneCom were entities under common control.

Pilicka is involved in the design, construction and operation of a telecommunications network in the Radom, Piotrków Trybunalski and Tarnobrzeg regions in Poland. During 1999, Pilicka was converted from a Polish S.A. to a Polish Sp. z o.o. The Company's founding members are comprised of three companies: Consolidated Companies, Inc., D&E Investments, Inc., a wholly-owned subsidiary of D&E Communications, Inc., and HunTel Systems, Inc. (the Founders).

On December 31, 2001, the Company and the Founders entered into an agreement with PenneCom whereby PenneCom transferred 100% of its shares in Pilicka to the Company and the Founders in exchange for partial satisfaction of loans and interest payable. The Company now owns 27.85% of Pilicka and for the year ended December 31, 2004, and 2003, accounted for its investment under the equity method of accounting.

NOTE 2. LIQUIDITY

The Company is dependent upon the Founders to provide the liquidity necessary for the Company to meet its cash flow requirements for the year 2005. In 2002, the Founders made equity capital contributions of \$2,344,331. In 2003 and 2004, the Founders made short-term advances of \$2,889,334 and \$1,908,000, respectively, which are recorded in Current Liabilities as Due to Founders.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICES*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its 100%-owned subsidiary, PenneCom. All material intercompany transactions have been eliminated in consolidation.

Cash and Cash Equivalents

All highly liquid investments with a maturity of three months or less at the time of purchase are considered cash equivalents.

Investment in Affiliate

The equity method of accounting is used when the Company has a 20% to 50% interest in other entities. Under the equity method, original investments are recorded at cost and adjusted by the Company's share of undistributed earnings or losses of these entities.

Table of Contents**EUROTEL, L.L.C.
LINCOLN, NEBRASKA****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
December 31, 2004, 2003 and 2002***Comprehensive Income (Loss)*

The Company has elected to present comprehensive income (loss) in the Statement of Members' Equity. Comprehensive income (loss) consists of the income (loss) for the period and the change in the foreign currency translation adjustment.

Income Taxes

EuroTel's taxable income passes to its members and therefore no taxes are recognized related to its operation. PenneCom B.V. is subject to 35% Dutch corporate tax. Since PenneCom has no taxable income in 2004, 2003 and 2002, no Dutch taxes have been recorded.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates.

Foreign Currency Translation

The financial position and results of operations of Pilicka are measured using the local currency, Polish zlotys, as the functional currency. Assets and liabilities of this subsidiary are translated at the exchange rate in effect at year-end. Income statement accounts are translated at the average rate of exchange prevailing during the year. Translation adjustments arising from differences in exchange rates from period to period are included in the cumulative other comprehensive income (loss) account in shareholder's equity. Foreign currency transaction gains and losses, as well as translation adjustments for monetary assets and liabilities of Pilicka that are denominated in currencies other than the Polish zloty, are recognized in the statement of operations. Certain foreign currency translations were recorded in 2002 as a result of the exchange of the Pilicka investment, see Note 4.

Property, Plant and Equipment

Property, plant and equipment are stated at cost. Expenditures for repairs and maintenance, which do not materially extend the useful lives of the related asset, are charged to expense as incurred. The cost of assets retired or otherwise disposed of, and the accumulated depreciation thereon, is removed from the accounts with any gain or loss realized upon sale or disposal charged or credited to operations.

Depreciation expense is recorded in the month following the commencement of use by applying the straight-line method over the estimated useful life of the assets: leasehold improvements and buildings (10-25 years), telecommunication equipment (10 years), and vehicles and other equipment (5-10 years). As of December 31, 2004 the Company had investments in property, plant, and equipment of \$1,403. Telephone plant is capitalized at original cost including the capitalized cost of salaries and wages, materials, certain payroll taxes, employee benefits, and interest incurred during the construction period.

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**EUROTEL, L.L.C.
LINCOLN, NEBRASKA**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
December 31, 2004, 2003 and 2002**

Concentration of Risk

Financial instruments, which potentially subject the Company to concentrations of risk, include cash and cash equivalents and trade receivables. The Company limits its risk associated with cash and cash equivalents by placing its investments with highly rated financial institutions, usually as short-term deposits. The Company maintains its checking accounts in three commercial banks. Cash in these checking accounts at times exceeded \$100,000. The Company has not experienced any losses in such accounts.

Reclassifications

Certain reclassifications have been made to the 2003 and 2002 consolidated financial statements to conform with the 2004 presentation.

NOTE 4. EXCHANGE OF PILICKA INVESTMENT

On December 31, 2001, the Company and the Founders entered into an agreement with PenneCom whereby PenneCom transferred 100% of its shares in Pilicka to the Company and the Founders in exchange for satisfaction of loans and interest payable totaling \$15,000,000 with an intended economic effect date of December 31, 2001. As a result of this agreement, the Company recognized a loss of \$31,517,480 in 2001, which represents the excess of the carrying value of the net assets over their net realizable value. The actual share transfer occurred in May 2002. The Company received a 22.56% ownership interest in Pilicka, valued at \$3,383,586, as a result of the share transfer. The net assets of Pilicka at December 31, 2001 which were deconsolidated in 2002 are as follows:

Cash	\$ 696,334
Receivables and other current assets	1,729,662
Property, plant and equipment	13,265,980
Intangible assets	1,563,054
Other non-current assets	185,415
Payables and accrued liabilities	(3,064,387)
Deferred revenues	(1,409,450)
Cumulative translation adjustment	2,033,392
Total net assets	<u>\$15,000,000</u>

NOTE 5. INVESTMENT IN AFFILIATE

As disclosed in Note 4, the Company received an ownership interest in Pilicka in exchange for the partial satisfaction of loans and interest payable. In addition, the Company contributed additional capital of \$1,100,000 during 2002 to increase its ownership percentage to 27.85%. The investment is being accounted for using the equity method.

Investment in affiliate was recorded in the Consolidated Balance Sheets at December 31, 2004 and 2003 of \$0 and \$2,386,208, respectively.

Pilicka had a net loss of \$23,237,000 in 2004. The Company's portion of the net loss was \$6,471,505, of which \$2,386,208 was recorded and \$4,085,297 was not recorded.

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**EUROTEL, L.L.C.
LINCOLN, NEBRASKA**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
December 31, 2004, 2003 and 2002**

The financial position and results of operations of the Company's equity basis investment are summarized below:

	2004	2003
Condensed balance sheet information:		
Current asset	\$ 6,164,000	\$ 2,816,000
Noncurrent assets	25,471,000	41,106,000
Total assets	<u>\$ 31,635,000</u>	<u>\$43,922,000</u>
Current liabilities	2,405,000	1,811,000
Noncurrent liabilities	745,000	932,000
Shareholders' equity	28,485,000	41,179,000
Total liabilities and equity	<u>\$ 31,635,000</u>	<u>\$43,922,000</u>
Condensed income statement information:		
Operating revenues	\$ 14,131,000	\$10,548,000
Operating expenses	37,681,000	13,752,000
Operating loss	(23,550,000)	(3,204,000)
Other income (expense)	313,000	(232,000)
Net loss	<u>\$ (23,237,000)</u>	<u>\$ (3,436,000)</u>

Reconciliation of equity investment at December 31, 2004 and 2003 is as follows:

	2004	2003
Beginning balance and initial transfer	\$ 2,386,208	\$3,343,134
Capital contributions	—	—
Allocation of loss	(2,386,208)	(956,926)
	<u>\$ 0</u>	<u>\$2,386,208</u>

NOTE 6. LOAN RECEIVABLE

In July 2000, the Company loaned United Food Technologies BV (UFT) \$500,000 to expand its network of Wendy's restaurants in Hungary. UFT owns equity interests in companies operating Wendy's franchises. The loan earns interest at 20% (10% during the first year) and was due in July 2002. During 2002 interest income related to the loan was \$73,425.

During 2002, it was determined that the note receivable and related accrued interest were uncollectible. A loss of \$596,849 was recognized in 2002 based on the write-off of the note receivable and accrued interest.

NOTE 7. DUE TO FOUNDERS

Due to Founders consists of the following at December 31, 2004 and 2003:

	2004	2003
Accounts payable to Founders	14,687,669	12,719,593
Accrued interest on accounts payable to Founders	1,757,182	1,757,182
Advances payable to Founders	17,263,529	17,263,529
	<u>\$33,708,380</u>	<u>\$31,740,304</u>

Table of Contents**EUROTEL, L.L.C.
LINCOLN, NEBRASKA****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
December 31, 2004, 2003 and 2002**

Accounts payable to Founders represent operating costs paid on behalf of the Company by those entities. Interest accrued on the accounts payable through December 2001 at the rate of 15% (7% through February 1999). Beginning in 2002, the Company discontinued the interest accrual on these obligations as all operating expenses advanced by the Founders are being reimbursed on a current basis. In 2004 and 2003, the Founders advanced funds in the amount of \$2,889,334 and \$1,908,000 respectively.

The loans payable bear interest at a fixed rate of 15%. Interest was accrued on the loans through December 2001. Like the accounts payable, the Company discontinued the accrual on interest on these obligations in 2002.

NOTE 8. FAIR VALUE OF FINANCIAL INSTRUMENTS

The fair value of financial instruments was estimated based on the following methods and assumptions:

Cash and cash equivalents, accounts receivable and accounts payable: The carrying amount approximates fair value due to the short maturity of these instruments.

Due to Founders: It is not practicable to estimate fair value of these instruments due to the related party nature and unique features of the instruments.

NOTE 9. LOSS ON INVESTMENT IN AFFILIATE

During 2002, EuroTel executed a contract to repurchase a 9% interest in PenneCom, which had been previously awarded to an affiliate. The value of the 9% interest on the date of award has been recognized as general and administrative expense. The amount of the payments in excess of the amount recorded as general and administrative expense has been recorded, and to the extent future payments are made will be recorded, as an additional investment in PenneCom. Because PenneCom has neither assets nor operating revenues, and because any future value is highly speculative, the Company has recorded a loss for all repurchase proceeds paid in 2002 in excess of the amount recorded as general and administrative expense.

NOTE 10. INCOME TAXES*United States*

EuroTel's taxable income passes to its members and therefore no taxes are recognized related to its operations.

Netherlands

PenneCom is subject to 35% Dutch corporate tax. However, any benefits derived from "qualifying subsidiaries," which includes Pilicka, are exempt from Dutch tax. All proceeds derived from the arbitration relating to the sale of Pilicka fall within that exempt category. In conjunction with the above, all costs that are attributable to such qualifying subsidiaries are not deductible for Dutch tax purposes. Also, the loss that PenneCom has recorded on the transfer of Pilicka in partial satisfaction of its debt to its various creditors will not be deductible. As a result, PenneCom has no taxable profit or loss for 2004, 2003, and 2002. Therefore, no Dutch taxes have been recorded related to PenneCom.

Table of Contents**EUROTEL, L.L.C.
LINCOLN, NEBRASKA****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
December 31, 2004, 2003 and 2002****NOTE 11. RELATED PARTY TRANSACTIONS**

The Company paid \$751,070, \$503,657, and \$797,746 to the Founders for various management, accounting, and other administrative functions during the years ended December 31, 2004, 2003, and 2002, respectively. These amounts are included in general and administrative expenses and in litigation costs related to sale of affiliate in the Consolidated Statements of Operations.

In 2002, the Company paid \$307,341 to a law firm for legal services where one of the lawyers was a managing director of the Company. This amount is included in litigation costs related to sale of affiliate and general and administrative expenses in the Consolidated Statements of Operations.

NOTE 12. GAIN CONTINGENCY

In July 2002, the Company, through its subsidiary PenneCom, initiated a legal action against an investment bank, and an individual, alleging violations of applicable law relating to the advice given by the investment bank and the individual to a prospective buyer not to close on the purchase of Pilicka. On June 28, 2004, the Second Circuit Court of Appeals reversed an order of the United States District Court for the Southern District of New York, which earlier had dismissed the case. Management of the Company continues to believe that, based on the advice of its legal counsel, the suit is meritorious. However, the ultimate outcome of the litigation cannot be determined and no amount has been recognized for possible collection of any claims in the litigation. Legal costs are expected to continue to be incurred in pursuit of such litigation.

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Pilicka Telefonía Sp. z o.o.

Financial Statements

December 31, 2004

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Table of Contents**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM****To the Supervisory Board and Shareholders' of Pilicka Telefonía Sp. z o.o.**

We have audited the accompanying balance sheets of Pilicka Telefonía Sp. z o.o. (the "Company") as of December 31, 2004 and 2003 and the related statements of operations, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (U.S.). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company at December 31, 2004 and 2003, and the results of its operations, changes in shareholders' equity and its cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

PRICEWATERHOUSECOOPERS SP. Z O.O.

Warsaw, Poland
March 1, 2005

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Table of Contents**Pilicka Telefonía Sp. z o.o.****Balance Sheets****(All amounts in thousands)**

	<u>Note</u>	<u>December 31, 2003 (PLN)</u>	<u>December 31, 2004 (PLN)</u>	<u>Convenience Translation \$ (Note 2) December 31, 2004 (Unaudited)</u>
Assets				
Current assets				
Cash and cash equivalents		3,212	10,886	3,641
Trade receivables, net of allowance for doubtful accounts of PLN 2,348 at December 31, 2003 and PLN 2,845 at December 31, 2004		6,389	6,589	2,203
Other current assets	3,8	931	957	320
Total current assets		10,532	18,432	6,164
Property and equipment, net	4,5	139,588	70,032	23,419
Intangible assets, net	4,6	13,651	5,094	1,703
Other long-term assets	8	518	1,045	349
Total assets		164,289	94,603	31,635
Liabilities and shareholders' equity				
Current liabilities				
Short-term debt	10	—	2,000	669
Accounts payable	7	4,693	4,117	1,377
Accrued expenses		816	642	214
Deferred revenue	9	1,266	435	145
Total current liabilities		6,775	7,194	2,405
Long term debt	10	—	1,964	657
Long-term liabilities for licenses	6	2,924	—	—
Deferred revenue	9	561	262	88
Total liabilities		10,260	9,420	3,150
Contingencies and commitments	14,15	—	—	—
Shareholders' equity				
Share capital, issued and outstanding 226,491 common shares at December 31, 2003 and 2004, par value PLN 500 per share	11	113,246	113,246	37,869
Additional paid-in capital		152,093	152,735	51,075
Accumulated deficit		(111,310)	(180,798)	(60,459)
Total shareholders' equity		154,029	85,183	28,485
Total liabilities and shareholders' equity		164,289	94,603	31,635

John Tesmer
PresidentBrian Bode
Financial DirectorRadom, Poland
March 1, 2005

The accompanying notes are an integral part of the financial statements.

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Pilicka Telefonía Sp. z o.o.
Statements of Operations
(All amounts in thousands)

	Note	Year ended			Convenience Translation \$ (Note 2)
		December 31, 2002 (PLN)	December 31, 2003 (PLN)	December 31, 2004 (PLN)	December 31, 2004 (Unaudited)
Revenue					
Telecommunication services revenue		36,593	37,481	40,970	13,700
Installation fees and sales of equipment		2,061	1,973	1,289	431
		<u>38,654</u>	<u>39,454</u>	<u>42,259</u>	<u>14,131</u>
Operating expenses					
Salaries and benefits		(9,209)	(9,381)	(9,827)	(3,286)
Depreciation and amortization		(20,476)	(21,125)	(21,172)	(7,080)
Impairment loss		(505)	(977)	(61,366)	(20,521)
Interconnection charges		(8,601)	(5,961)	(6,481)	(2,167)
Selling, general and administrative		(13,952)	(13,843)	(13,753)	(4,599)
Other operating expenses, net		(261)	(152)	(85)	(28)
		<u>(53,004)</u>	<u>(51,439)</u>	<u>(112,684)</u>	<u>(37,681)</u>
Operating loss		<u>(14,350)</u>	<u>(11,985)</u>	<u>(70,425)</u>	<u>(23,550)</u>
Financial income/(expense), net	12	(80)	(866)	937	313
Net loss		<u>(14,430)</u>	<u>(12,851)</u>	<u>(69,488)</u>	<u>(23,237)</u>

The accompanying notes are an integral part of the financial statements.

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Pilicka Telefonía Sp. z o.o.
Statements of Changes in Shareholders' Equity
(All amounts in thousands)

	<u>Share Capital</u> (PLN)	<u>Additional Paid-in Capital</u> (PLN)	<u>Accumulated Deficit</u> (PLN)	<u>Total</u> (PLN)
At January 1, 2002	109,068	150,637	(84,029)	175,676
Costs paid by shareholders	—	593	—	593
Net loss	—	—	(14,430)	(14,430)
At December 31, 2002	109,068	151,230	(98,459)	161,839
Common stock issued	4,178	—	—	4,178
Capital contributions from shareholders	—	299	—	299
Costs paid by shareholders	—	564	—	564
Net loss	—	—	(12,851)	(12,851)
At December 31, 2003	113,246	152,093	(111,310)	154,029
Costs paid by shareholders	—	642	—	642
Net loss	—	—	(69,488)	(69,488)
At December 31, 2004	113,246	152,735	(180,798)	85,183

The accompanying notes are an integral part of these financial statements.

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Table of Contents**Pilicka Telefonía Sp. z o.o.****Statements of Cash Flows****(All amounts in thousands)**

	Year ended			Convenience Translation \$ (Note 2)
	December 31, 2002	December 31, 2003	December 31, 2004	December 31, 2004
	(PLN)	(PLN)	(PLN)	(Unaudited)
Cash flows from operating activities:				
Net loss	(14,430)	(12,851)	(69,488)	(23,237)
Adjustments to reconcile net loss to net cash (used)/provided by operating activities:				
Depreciation and amortization	20,476	21,125	21,172	7,080
Impairment loss	505	977	61,366	20,521
Foreign exchange losses/(gains)	478	894	(573)	(192)
Loss on disposal of equipment	686	958	1,408	471
(Increase)/Decrease in trade receivables (gross)	(1,238)	38	(697)	(233)
Increase/(Decrease) in provision for doubtful accounts	935	(287)	498	167
Increase in other current assets	(621)	(119)	(130)	(43)
Increase/(Decrease) in accounts payable	420	(152)	307	103
Decrease in deferred revenue	(1,939)	(1,853)	(1,129)	(378)
Increase/(Decrease) in accrued expenses	218	(212)	(174)	(58)
Other	593	563	641	214
Net cash provided by operating activities	6,083	9,081	13,201	4,415
Cash flows from investing activities:				
Proceeds from the sale of equipment	248	237	165	55
Purchase of intangible assets	(99)	(134)	(267)	(89)
Expenditures for property and equipment	(10,937)	(8,277)	(9,389)	(3,140)
Net cash used in investing activities	(10,788)	(8,174)	(9,491)	(3,174)
Advances from shareholders	4,234	—	—	—
Proceeds from debt financing	—	—	3,964	1,326
Net cash provided by financing activities	4,234	—	3,964	1,326
Net (decrease)/ increase in cash and cash equivalents	(471)	907	7,674	2,567
Cash and cash equivalents at the beginning of period	2,776	2,305	3,212	1,074
Cash and cash equivalents at the end of period	2,305	3,212	10,886	3,641

The accompanying notes are an integral part of these financial statements.

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Pilicka Telefonía Sp. z o.o.
Statements of Cash Flows
 (All amounts in thousands)

Supplementary disclosure of cash flow information:

Non-cash investing and financing activities:

	Year ended			Convenience Translation \$ (Note 2)
	December 31, 2002	December 31, 2003	December 31, 2004	December 31, 2004
	(PLN)	(PLN)	(PLN)	(Unaudited)
Property, equipment and construction in progress costs included in accounts payable	1,806	2,041	1,126	377
Cash paid for interest on debt financing	—	—	254	85

The accompanying notes are an integral part of these financial statements.

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements
(All amounts in thousands)

1. The Company and Business

Pilicka Telefonía Sp. z o.o. ("Pilicka" or the "Company") was formed in 1997 as a joint stock company under the laws of Poland and was transformed into a limited liability company in 1999. The Company is incorporated in Poland with its principal executive office located at ul. Podkanowska 54 A, 26-600 Radom, Poland.

Pilicka has obtained three licenses from the Ministry of Communications of Poland to operate local telecommunication networks throughout the former Radom, Piotrków Trybunalski and Tarnobrzeg Voivodships in Poland for a period of fifteen years. The licenses for the former Radom and Piotrków Trybunalski Voivodships expire in 2010 and the license for the former Tarnobrzeg Voivodship expires in 2012. In 2002, under the New Telecommunication Law effective as of January 1, 2001, the Company was granted a telecommunication permit to operate telecommunication networks and render telecommunications services throughout the whole territory of Poland except for the networks, which are operated under the licenses already held by the Company. The new telecommunication permit has been granted for the period of twenty five-years.

The Company is involved in the design, construction and operation of a local telecommunications network, as well as in the installation and sale of telecommunication equipment. Pilicka's telecommunication services include fixed-line voice telephone service, Integrated Services Digital Network ("ISDN"), dial-up and fixed-access Internet (Wireless IP-Based Local Loop "WIPLL"), Voice over Internet Protocol ("VoIP") and Internet Protocol Virtual Private Network ("IP VPN").

2. Summary of Significant Accounting Policies**(a) Basis of presentation**

The Company maintains its accounting records and prepares statutory financial statements in accordance with Polish accounting and tax regulations. These financial statements have been prepared based upon the Company's accounting records in order to present the financial position, results of operations and of cash flows in accordance with accounting principles generally accepted in the United States of America ("US GAAP"), which differ in certain respects from the accounting principles applied by the Company in its financial statements prepared in accordance with Polish accounting regulations.

(b) US Dollar convenience translation (Unaudited)

The measurement currency is Polish Zloty ("PLN") that reflects the economic substance of the underlying events and circumstances of the Company. The US Dollar ("USD") amounts shown in the accompanying financial statements have been translated at December 31, 2004 and for the year ended December 31, 2004 from PLN only as a matter of arithmetic computation at the PLN exchange rate of PLN 2.9904 = USD 1.00, the rate published by the National Bank of Poland and effective on December 31, 2004. These amounts are unaudited and are included for the convenience of the reader only as supplementary information. Such translation should not be construed as a representation that the PLN amounts have been or could be converted into USD at this or any other rate.

(c) Cash and cash equivalents

The Company considers all highly liquid instruments purchased with a maturity from purchase date of three months or less to be cash and cash equivalents. Cash equivalents consist of overnight bank accounts.

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements—(Continued)
(All amounts in thousands)

(d) Embedded derivatives instruments

When the Company purchases a financial instrument or enters into other agreements in which a derivative instrument is “embedded”, it assesses whether the economic characteristics of the embedded derivative are clearly and closely related to the economic characteristics of the remaining component of the financial instrument (i.e., the host contract) and whether a separate, non-embedded instrument with the same terms as the embedded instrument would meet the definition of a derivative instrument. When it is determined that (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract and (2) a separate, stand-alone instrument with the same terms would qualify as a derivative instrument, the embedded derivative is separated from the host contract, carried at fair value with changes in the fair value of the derivatives recorded each period in statement of operations.

(e) Property, equipment and construction in progress

Property and equipment are stated at cost. Construction-in-progress represents the accumulation of costs associated with the construction of telephone networks and other tangible fixed assets. The Company continually monitors the progress of these construction projects and tracks each project by location. The Company capitalizes all costs that are directly attributable to the network development in construction-in-progress. Expenditures for repairs and maintenance, which do not materially extend the useful lives of the related asset, are charged to expense as incurred. The cost of assets retired or otherwise disposed of and the accumulated depreciation thereon are removed from the accounts with any gain or loss realized upon sale or disposal charged or credited to operations.

Depreciation expense is recorded by applying the straight-line method over the estimated useful life of the assets. The depreciation rates are summarized as follows:

	<u>Useful life</u>
Leasehold improvements and buildings	10–25 years
Telecommunication equipment	10 years
Vehicles and other equipment	5–10 years

(f) Telecommunication licenses

The intangible assets include the acquisition costs incurred in connection with the acquisition of licenses to provide telecommunication services. The licenses for the former Radom and Piotrków Trybunalski voivodships were acquired through the EuroTel L.L.C. purchase of the Company in 1997. Intangible assets also represent amounts paid to the Ministry of Communications of Poland for the purchase of license for the former Tarnobrzeg voivodship. Licenses are stated at cost less accumulated amortization and impairment charges. Amortization is recorded on a straight-line basis over the period for which the license is granted (see Note 1).

(g) Computer software

Costs that are directly associated with identifiable and unique software controlled by the Company and which have probable economic benefits beyond one year are recognized as intangible assets and amortized using the straight-line method over their useful lives, not exceeding a period of 5 years.

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements—(Continued)
(All amounts in thousands)

(h) Impairment of long-lived assets

The Company reviews its long-lived assets, including intangible assets, for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. The Company performs an undiscounted operating cash flow analyses to determine if impairment exists. If impairment is determined to exist, any related impairment loss is calculated based on fair value. Impairment losses on assets to be disposed of, if any, are based on the estimated proceeds to be received, less costs of disposal.

(i) Retirement benefits

The Company pays social security taxes on each employee to the Polish Government. The Company has no other employee retirement plans.

(j) Accounting for leases

Leases of assets where a significant portion of the risks and rewards of ownership are retained by the lessor are classified as operating leases. Payments made under operating leases are charged to the statement of operations on a straight-line basis over the period of the lease.

When an operating lease is terminated before the lease period has expired, any payment required to be made to the lessor by way of penalty is recognized as an expense in the period in which termination takes place.

(k) Revenues

Telecommunication service revenue from access to and the usage of telecommunication networks are recognized when the services are provided. Revenue from installation fees is recognized over the period of the average life of the customer, which is estimated to be five years for Pilicka.

(l) Advertising costs

All advertising costs are expensed as incurred. Advertising expenses for the years ended December 31, 2004, 2003 and 2002 were PLN 770, PLN 808, PLN 845, respectively.

(m) Foreign currency translation

Transactions denominated in foreign currencies have been translated into PLN at actual rates of exchange ruling at the date of transaction. Monetary assets and liabilities denominated in foreign currencies have been translated at rates ruling at the balance sheet date. Exchange differences have been included in financial income/(expenses).

(n) Comparative financial information

Where necessary, comparative figures have been adjusted to conform to changes in presentation in the current year. No amendments have resulted in changes to previously presented net results or shareholders' equity.

Table of Contents**Pilicka Telefonía Sp. z o.o.****Notes to the Financial Statements—(Continued)**
(All amounts in thousands)**(o) Financial Instruments**

Financial instruments that potentially subject the Company to concentrations of credit risk include cash, cash equivalents and trade receivables. The Company limits its credit risk associated with cash and cash equivalents by placing its investments with highly rated financial institutions, usually as short-term deposits. With respect to trade receivables, the Company limits its credit risk by disconnecting service for certain customers who are past due with respect to their payments.

(p) Income taxes

Income taxes are computed using the liability method. Under this method, deferred income tax assets and liabilities are determined based on temporary differences between the financial reporting and tax bases of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse. Valuation allowances are established against deferred tax assets where it is more likely than not that some portion or all of the asset will not be realized.

(q) Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

3. Other Current Assets

	December 31, 2003 (PLN)	December 31, 2004 (PLN)
Prepaid expenses	590	613
Embedded derivative financial instruments (see Note 8)	138	200
Other current assets	203	144
	<u>931</u>	<u>957</u>

4. Impairment of Long-Lived Assets

The continuing significant changes in current and expected market conditions, which followed the full liberalization of the telecommunications market, resulted in the revision of the Company's business plans. The new business plan was approved by the Supervisory Board in November 2004. The revised financial projections led the Company to evaluate its long-lived assets for their possible impairment.

For the purpose of the impairment test, the entire Company was identified as an asset group. In accordance with SFAS 144, impairment loss of an asset is measured as the amount by which an asset's carrying amount exceeds its fair value. When the fair value of the asset cannot be derived from market prices of comparable assets traded in active markets, valuation techniques based on the estimates of future cash flows can be applied. Future cash flows were derived from the financial projections of the newly approved business plan for 2005-2006 and additional financial forecasts prepared by the Company's management for the period 2007-2009. After that period, the projections, prepared for the purposes of the impairment test, make use of an EV/EBITDA multiple of

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements—(Continued)
(All amounts in thousands)

5.5 to calculate a terminal value, which is compatible with the industry projections for the operations concerned. The discount rate used of 13.3% represented the estimated risk adjusted cost of capital at the time, when the impairment test was performed.

The test resulted in an impairment charge of PLN 61,366, which was recognized as a separate item in the statement of operations for the year ended December 31, 2004 and was allocated to the long-lived assets on a pro rata basis. The impact of the impairment charge on the particular groups of assets is as follows:

	Year ended December 31, 2004 (PLN)
Land, buildings and leasehold improvements	12,161
Telecommunication equipment	40,023
Vehicles and other equipment	648
Construction-in-progress	4,466
Property and equipment	57,298
Intangible assets	4,068
	<u>61,366</u>

5. Property and Equipment

	December 31, 2004		
	Cost	Accumulated amortization and impairment charges	Net
	(PLN)	(PLN)	(PLN)
Land, buildings and leasehold improvements	37,871	23,008	14,863
Telecommunication equipment	168,859	119,942	48,917
Vehicles and other equipment	5,522	4,729	793
Construction-in-progress	14,719	9,260	5,459
	<u>226,971</u>	<u>156,939</u>	<u>70,032</u>

	December 31, 2003		
	Cost	Accumulated depreciation and impairment charges	Net
	(PLN)	(PLN)	(PLN)
Land, buildings and leasehold improvements	37,504	8,799	28,705
Telecommunication equipment	161,095	63,839	97,256
Vehicles and other equipment	4,810	3,641	1,169
Construction-in-progress	17,252	4,794	12,458
	<u>220,661</u>	<u>81,073</u>	<u>139,588</u>

Table of Contents**Pilicka Telefonía Sp. z o.o.****Notes to the Financial Statements—(Continued)**
(All amounts in thousands)

The Company has recorded a charge for the impairment of PLN 61,366 during the year ended December 31, 2004 in relation to its long-lived assets held for use of which PLN 57,298 relates to property and equipment (see Note 4), and a charge for the impairment of PLN 977 and PLN 505 during the years ended December 31, 2003 and 2002, respectively, in relation to certain telecommunication equipment and construction projects, initially held for use, which are not expected to be further utilized.

Depreciation expense for the year ended December 31, 2004, 2003 and 2002 was PLN 19,419, PLN 18,812 and PLN 18,144, respectively.

6. Intangible Assets

	December 31, 2004		
	Cost	Accumulated amortization and impairment charges	Net
	(PLN)	(PLN)	(PLN)
Telecommunications license	25,124	20,422	4,702
Computer software	3,751	3,359	392
	<u>28,875</u>	<u>23,781</u>	<u>5,094</u>

	December 31, 2003		
	Cost	Accumulated amortization	Net
	(PLN)	(PLN)	(PLN)
Telecommunication license	25,124	11,949	13,175
Computer software	3,875	3,399	476
	<u>28,999</u>	<u>15,348</u>	<u>13,651</u>

The Company has recorded a charge for the impairment of PLN 61,366 for the year ended December 31, 2004 in relation to its long-lived assets of which PLN 4,068 relates to intangible assets (see Note 4).

Amortization expense for the year ended December 31, 2004, 2003 and 2002 was PLN 1,753, PLN 2,313 and PLN 2,332, respectively. As of December 31, 2004, the estimated aggregate amortization of intangible assets for the years 2005 to 2009 is as follows: 2005—PLN 1,518; 2006—PLN 1,437; 2007—PLN 1,404 and 2008—PLN 1,381 and 2009—PLN 1,363.

On the basis of the Act of November 23, 2002 on restructuring of license liabilities of non-mobile public telephone network operators the Company has applied in 2003 to the Polish Regulator, URTiP ("Urząd Regulacji Telekomunikacji i Poczty"), for the forgiveness of the remaining obligation for its telecommunication license. The Company received the final decision of forgiveness in March 2004. Following the receipt of this decision, on March 31, 2004 the Company has offset the remaining license liability of PLN 3,004 in correspondence with the related intangible asset of PLN 3,772. The remaining asset of PLN 768 as at March 31, 2004 is depreciated on a straight-line basis by December 31, 2012, when the license expires.

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements—(Continued)
(All amounts in thousands)

7. Accounts Payable

	<u>December 31,</u> <u>2003</u> <u>(PLN)</u>	<u>December 31,</u> <u>2004</u> <u>(PLN)</u>
Trade accounts payable	3,479	2,673
Government payables	971	1,257
Other accounts payable	243	187
	<u>4,693</u>	<u>4,117</u>

8. Embedded Derivative Instruments

The Company has entered into lease agreements in the prior years that require payments denominated in a currency other than the functional currency of the Company or the lessor. Under the provisions of the Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" and its related amendments these embedded foreign currency derivatives must be bifurcated from the lease agreements and separately accounted for.

The positive fair value of these embedded foreign currency derivatives was PLN 1,245 and PLN 656 as at December 31, 2004 and 2003, respectively. The fair value of these embedded foreign currency derivatives has been classified as other current assets (PLN 200 and PLN 138 as at December 31, 2004 and 2003, respectively) and other long-term assets (PLN 1,045 and PLN 518 as at December 31, 2004 and 2003, respectively).

9. Deferred Revenue

The Company recorded deferred revenue at December 31, 2004 and 2003 of PLN 697 (PLN 435 current and PLN 262 non-current) and PLN 1,827 (PLN 1,266 current and PLN 561 non-current), respectively, in connection with the revenue recognition policy based on the Staff Accounting Bulletin No. 104, "Revenue Recognition".

10. Bank Loan

On December 15, 2003, the Company entered into a loan agreement with its bank. As per the agreement, a bank loan dedicated for capital expenditures was provided to the company in installments starting on January 20, 2004 to December 31, 2004 and repayable in installments from March 31, 2005 to December 31, 2006. As of December 31, 2004 the amount of PLN 3,964 of the loan was outstanding with PLN 2,000 classified as short-term debt and PLN 1,964 as long-term debt. Interest amounts to 3-month WIBOR + 3 p.p. The net book value of assets pledged as collateral as of December 31, 2004 amounts to PLN 6,399. In addition to assets already pledged, certain assets purchased within the investment project financed by this credit will be pledged as collateral.

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements—(Continued)
(All amounts in thousands)

11. Share Capital

The Company's share capital consisted of 226,491 common, issued and outstanding shares as of December 31, 2004 and 2003, respectively. Each common share had one vote at shareholders meetings. The par value of these shares is 500 PLN. The ownership structure as at December 31, 2004 and 2003 is presented below:

	<u>No of shares</u>	<u>%</u>
D&E Investments, Inc.	65,410	28.88
EuroTel L.L.C.	63,078	27.85
HunTel Systems, Inc.	55,468	24.49
Consolidated Companies, Inc.	42,535	18.78
	<u>226,491</u>	<u>100.00</u>

12. Financial Income/(Expenses), net

	<u>Year ended</u>		
	<u>December 31,</u> <u>2002</u> <u>(PLN)</u>	<u>December 31,</u> <u>2003</u> <u>(PLN)</u>	<u>December 31,</u> <u>2004</u> <u>(PLN)</u>
Interest income	133	161	405
Interest expense	(218)	(308)	(255)
Fair value gains on embedded derivatives	22	(242)	589
Foreign exchange gains	262	93	242
Foreign exchange losses	(279)	(570)	(44)
	<u>(80)</u>	<u>(866)</u>	<u>937</u>

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements—(Continued)
(All amounts in thousands)

13. Income Taxes

Enacted Corporate Income Tax rate in Poland were 19% in 2004, 27% in 2003 and 28% in 2002. The Company has incurred tax losses since the commencement of its operations and, therefore, it has not paid income taxes.

Below is the analysis of deferred income taxes:

	December 31, 2003 (PLN)	December 31, 2004 (PLN)
Deferred tax assets:		
Impairment charges	911	11,831
Net operating losses	1,796	2,050
Net operating loss carry forwards	9,399	8,456
Allowance for doubtful accounts	435	541
Deferred revenue	338	132
Accruals	128	51
Amortization for license	102	—
Unrealized foreign exchange differences	172	—
	<u>13,281</u>	<u>23,061</u>
Valuation allowance	(12,830)	(22,969)
Deferred tax assets, net	451	92
Deferred tax liabilities:		
Amortization for license	—	75
Future interest charges on license liability	451	—
Unrealized foreign exchange differences	—	17
	<u>451</u>	<u>92</u>
Net deferred tax asset	<u>—</u>	<u>—</u>

A full valuation allowance was recorded, as the Company does not expect to recover any deferred tax assets through future tax deductions.

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Pilicka Telefonía Sp. z o.o.
Notes to the Financial Statements—(Continued)
(All amounts in thousands)

Below is the analysis of the amounts and expiration dates of net operating losses and net operating loss carry forwards:

	December 31, 2003 (PLN)	December 31, 2004 (PLN)
Net operating losses		
2007	898	—
2008	898	1,025
2009	—	1,025
	<u>1,796</u>	<u>2,050</u>
Net operating loss carry forwards		
2004	2,740	—
2005	3,180	3,180
2006	2,423	2,423
2007	1,056	1,955
2008	—	898
	<u>9,399</u>	<u>8,456</u>

14. Contingencies and Commitments

Operating lease commitments were mainly in respect of the lease contracts for office space and telecommunication equipment land. There were non-cancelable operating leases of PLN 3,642 and PLN 5,525 as at December 31, 2004 and 2003, respectively. Rent expense for the year ended December 31, 2004, 2003 and 2002 was PLN 2,248, PLN 2,196 and PLN 2,177, respectively.

As of December 31, 2004, the minimum lease payments for each of the years from 2005 to 2008 amount to PLN 471, and for the years 2008 and thereafter amounts to PLN 1,757.

15. Tax contingent liability

Regulations relating to value-added tax, corporate income tax, and payroll (social) taxes have been radically changed in comparison to the tax regulations, which existed prior to the economic and political transformation in Poland. The lack of reference to well-established regulations and the relatively short period in which these new tax regulations have been in place results in there being a lack of clarity and integrity in the regulations. Frequent contradictions in legal interpretations both within government bodies and between companies and government bodies create uncertainties and conflicts. Tax settlements, together with other areas of legal compliance areas (e.g. customs or foreign exchange law) are subject to review and investigation by a number of authorities, which are entitled to impose severe fines, penalties and interest charges. These facts create tax risks in Poland that are substantially more significant than those typically found in countries with more developed tax system. The tax authorities may at any time inspect the books and records and may impose additional tax assessments with penalty interest and penalties within 5 years from the end of the year when a tax is due. Management does not believe that these circumstances will have a material adverse effect on the Company's financial condition.

Table of Contents**Pilicka Telefonía Sp. z o.o.****Notes to the Financial Statements—(Continued)
(All amounts in thousands)****16. Related Party Transactions**

The Company has paid PLN 486, PLN 562 and PLN 502 to an affiliated entity for management services and the purchase of rights to use software during the year ended December 31, 2004, 2003 and 2002, respectively. There was no amount payable to this affiliate at December 31, 2004 (PLN 40 at December 31, 2003). The Company has also made rental payments of PLN 562, PLN 698 and PLN 767 to a company partially owned by a relative of a member of the Company's Management Board during the year ended December 31, 2004, 2003 and 2002, respectively. There was no amount payable to this affiliate at December 31, 2004 and 2003.

17. Non-cash transactions

There were costs of PLN 641, PLN 564 and PLN 593 paid by shareholders in connection with the Company's affairs during the year ended December 31, 2004, 2003 and 2002, respectively.

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EXHIBIT 4

**[EXHIBIT 4 IS PROPRIETARY
AND THEREFORE IS NOT INCLUDED
WITH THIS EXPURGATED VERSION
OF THE TESTIMONY]**

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FOLDER**

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JUN 18 2007

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EXHIBIT 5

**[EXHIBIT 5 IS PROPRIETARY
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EXHIBIT 6

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Comparative D&E Rates - State to Interstate

BASED ON NECA 2005 RATES AS REFERENCED
IN BEURER DIRECT TESTIMONY STARTING ON
P. 57

Rate element	D&E PA PUC No. 16	D&E Interstate (Rates Eff 07/05)	Rate Difference- State Minus Interstate **	Buffalo Valley PA PUC No. 8	BVT Interstate (Rates Eff 07/05)	Rate Difference- State Minus Interstate **	Conestoga PA PUC No. 11	Conestoga Interstate (Rates Eff 07/05)	Rate Difference- State Minus Interstate **
Carrier Common Line									
CCL - Per Line	\$ 5.1700000		\$ 5.1700000	\$ 5.1100000		\$ 5.1100000	\$ 4.4400000	\$ -	\$ 4.4400000
CCL-Per MOU	\$ 0.0322040		\$ 0.0322040	\$ 0.0258360		\$ 0.0258360	\$ 0.02377200	\$ -	\$ 0.0237720
END OFFICE									
Local Switching	\$ 0.01783700	\$ 0.01783700	\$ -	\$ 0.01070200	\$ 0.01070200	\$ -	\$ 0.01783700	\$ 0.01783700	\$ -
Shared End Office Trunk Port	\$ -		\$ -	\$ -		\$ -	\$ -	\$ -	\$ -
Information Surcharge	\$ 0.00011570	\$ 0.00019200	\$ (0.0000763)	\$ 0.00007560	\$ 0.00019200	\$ (0.0001164)	\$ 0.00011425	\$ 0.00019200	\$ (0.0000778)
TANDEM SWITCHED TRANSPORT									
Tandem Switched Transport Facility (All Zones) - Per MOU per Mile	\$ 0.0001790	\$ 0.0001640	\$ 0.0000150	\$ 0.0000360	\$ 0.0001640	\$ (0.0001280)	\$ 0.0001760	\$ 0.0001640	\$ 0.0000120
Tandem Switched Transport Termination (All Zones) - Per MOU (Per Term)*	\$ 0.0008800	\$ 0.0008070	\$ 0.0000730	\$ 0.0001840	\$ 0.0008070	\$ (0.0006230)	\$ 0.0008690	\$ 0.0008070	\$ 0.0000620
Tandem Switching (All Zones) - Per MOU	\$ 0.0027870	\$ 0.0027870	\$ -	\$ 0.0027870	\$ 0.0027870	\$ -	\$ 0.0027870	\$ 0.0027870	\$ -
Transport Multiplexing	\$ -	\$ -	\$ -	\$ -		\$ -	\$ -	\$ -	\$ -
Transport Interconnection	\$ 0.0055120	\$ -	\$ 0.0055120	\$ 0.0053790	\$ -	\$ 0.0053790	\$ 0.0054440	\$ -	\$ 0.0054440
TOTAL TRAFFIC SENSITIVE	\$ 0.0273197	\$ 0.0217870	\$ 0.0055237	\$ 0.0191636	\$ 0.0146520	\$ 0.0045116	\$ 0.0272273	\$ 0.0217870	\$ 0.0054403
Total Composite MOU Rate	\$ 0.0595147	\$ 0.0217870	\$ 0.0377277	\$ 0.0449996	\$ 0.0146520	\$ 0.0303476	\$ 0.0509993	\$ 0.0217870	\$ 0.0292123

** Where amount is positive, the intrastate rate for that rate element exceeds the corresponding interstate rate. Where negative, the interstate rate is higher.

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**RESPONSE
OF THE D&E COMPANIES
TO INTERROGATORIES OF THE VERIZON COMPANIES, SET I
IN 2006 ANNUAL PRICE STABILITY INDEX/SERVICE PRICE INDEX FILING
DOCKET NOS. P-00981428F1000; P-00981429F1000; P-00981430F1000**

Witness: Leonard Beurer, Vice President
Response to VZ 1-7

7. For each of the companies D&E, Buffalo Valley and Conestoga, please provide the most recent available study of the cost of providing switched access service. If no such study exists, please so state.

Response:

Subject to and without waiver of the objection, the Companies state that they are price regulated, rather than cost regulated companies for intrastate purposes and that they are average schedule, as opposed to cost companies for interstate purposes. Consequently, the Companies do not develop intrastate cost studies by service class. The Companies have relied on prior Commission orders approving the use of interstate rates as appropriate for intrastate pricing and have also approved the use of the National Exchange Carrier Association ("NECA") rates as appropriate for companies which are part of the NECA pool. Furthermore, the Companies are unaware of any Commission cost allocation rules or cost modeling programs applicable to rural ILECs that specifically identify how individual service costs are to be calculated.