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CITIZENS COMMUNICATIONS CO

Form 10-Q

August 03, 2006

CITIZENS COMMUNICATIONS COMPANY

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006  
-----

or

--

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-11001  
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CITIZENS COMMUNICATIONS COMPANY  
-----

(Exact name of registrant as specified in its charter)

Delaware  
-----

06-0619596  
-----

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(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

3 High Ridge Park  
Stamford, Connecticut

06905

-----  
(Address of principal executive offices)

-----  
(Zip Code)

(203) 614-5600

-----  
(Registrant's telephone number, including area code)

N/A

-----  
(Former name, former address and former fiscal year, if changed since last report)

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 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 Exchange Act).

Yes  No   
--- ---

The number of shares outstanding of the registrant's Common Stock as of July 31, 2006 was 320,833,416.

CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES

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Part I. Financial Information (Unaudited)

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Consolidated Balance Sheets at June 30, 2006 and December 31, 2005

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Consolidated Statements of Operations for the six months ended June 30, 2006 and 2005

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Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2006 and 2005

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## PART I. FINANCIAL INFORMATION

### Item 1. Financial Statements

CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(\$ in thousands)

(Unaudited  
June 30, 20

#### ASSETS

-----

#### Current assets:

|   |    |     |
|---|----|-----|
| Cash and cash equivalents   | \$ | 141 |
| Accounts receivable, less allowances of \$52,904 and \$31,631, respectively |    | 195 |

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|  |          |
|--|----------|
| Other current assets   | 37       |
| Assets of discontinued operations  | 162      |
|  | -----    |
| Total current assets   | 536      |
| Property, plant and equipment, net   | 2,978    |
| Goodwill, net  | 1,921    |
| Other intangibles, net   | 495      |
| Investments  | 16       |
| Other assets   | 196      |
|  | -----    |
| Total assets   | \$ 6,145 |
|  | =====    |
| LIABILITIES AND STOCKHOLDERS' EQUITY   |          |
| -----  |          |
| Current liabilities:   |          |
| Long-term debt due within one year   | \$ 47    |
| Accounts payable and other current liabilities   | 334      |
| Liabilities of discontinued operations   | 44       |
|  | -----    |
| Total current liabilities  | 426      |
| Deferred income taxes  | 411      |
| Other liabilities  | 432      |
| Long-term debt   | 3,950    |
| Stockholders' equity:  |          |
| Common stock, \$0.25 par value (600,000,000 authorized shares; 320,684,000 and 328,168,000 outstanding, respectively, and 343,956,000 issued at June 30, 2006 and December 31, 2005) | 85       |
| Additional paid-in capital   | 1,203    |
| Retained earnings (deficit)  | 66       |
| Accumulated other comprehensive loss, net of tax   | (123)    |
| Treasury stock   | (309)    |
|  | -----    |
| Total stockholders' equity   | 924      |
|  | -----    |
| Total liabilities and stockholders' equity   | \$ 6,145 |
|  | =====    |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

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PART I. FINANCIAL INFORMATION (Continued)

CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE THREE MONTHS ENDED JUNE 30, 2006 AND 2005  
(\$ in thousands, except per-share amounts)  
(Unaudited)

2006

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|   |            |
|---|------------|
| Revenue   | \$ 506,912 |
| Operating expenses:   |            |
| Cost of services (exclusive of depreciation and amortization) | 38,402     |
| Other operating expenses                                      | 179,500    |
| Depreciation and amortization                                 | 119,552    |
|   | -----      |
| Total operating expenses                                      | 337,454    |
|   | -----      |
| Operating income  | 169,458    |
| Investment and other income (loss), net                       | 65,363     |
| Interest expense  | 85,341     |
|   | -----      |
|   | -----      |
| Income from continuing operations before income taxes         | 149,480    |
| Income tax expense  | 54,734     |
|   | -----      |
|   | -----      |
| Income from continuing operations                             | 94,746     |
| Discontinued operations (see Note 5):                         |            |
| Income from operations of discontinued CLEC business          | 11,482     |
| Income tax expense  | 4,526      |
|   | -----      |
|   | -----      |
| Income from discontinued operations                           | 6,956      |
|   | -----      |
|   | -----      |
| Net income available to common stockholders                   | \$ 101,702 |
|   | =====      |
|   | =====      |
| Basic income per common share:                                |            |
| Income from continuing operations                             | \$ 0.30    |
| Income from discontinued operations                           | 0.02       |
|   | -----      |
|   | -----      |
| Net income available to common stockholders                   | \$ 0.32    |
|   | =====      |
|   | =====      |
| Diluted income per common share:                              |            |
| Income from continuing operations                             | \$ 0.29    |
| Income from discontinued operations                           | 0.02       |
|   | -----      |
|   | -----      |
| Net income available to common stockholders                   | \$ 0.31    |
|   | =====      |
|   | =====      |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

PART I. FINANCIAL INFORMATION (Continued)

CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE SIX MONTHS ENDED JUNE 30, 2006 AND 2005  
(\$ in thousands, except per-share amounts)  
(Unaudited)

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|  | 2006      |
|--|-----------|
| Revenue  | \$ 1,013, |
| Operating expenses:  |           |
| Cost of services (exclusive of depreciation and amortization)  | 78,       |
| Other operating expenses   | 366,      |
| Depreciation and amortization  | 241,      |
| Total operating expenses   | 686,      |
| Operating income   | 326,      |
| Investment and other income (loss), net  | 64,       |
| Interest expense   | 170,      |
| Income from continuing operations before income taxes  | 220,      |
| Income tax expense   | 81,       |
| Income from continuing operations  | 138,      |
| Discontinued operations (see Note 5):  |           |
| Income from operations of discontinued CLEC business   | 21,       |
| Income from operations of discontinued conferencing business<br>(including gain on disposal of \$14,061) | 8,        |
| Income tax expense   | 8,        |
| Income from discontinued operations  | 13,       |
| Net income available to common stockholders  | \$ 152,   |
| Basic income per common share:   |           |
| Income from continuing operations  | \$ 0      |
| Income from discontinued operations  | 0         |
| Net income available to common stockholders  | \$ 0      |
| Diluted income per common share:   |           |
| Income from continuing operations  | \$ 0      |
| Income from discontinued operations  | 0         |
| Net income available to common stockholders  | \$ 0      |

The accompanying Notes are an integral part of these Consolidated Financial Statements.

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PART I. FINANCIAL INFORMATION (Continued)

CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES  
 CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
 FOR THE YEAR ENDED DECEMBER 31, 2005 AND THE SIX MONTHS ENDED JUNE 30, 2006  
 (\$ in thousands)  
 (Unaudited)

|  | Common Stock |          | Additional         | Retained              | Accumulated                    | Tr   |
|--|--------------|----------|--------------------|-----------------------|--------------------------------|------|
|  | Shares       | Amount   | Paid-In<br>Capital | Earnings<br>(Deficit) | Other<br>Comprehensive<br>Loss | Shar |
| Balance January 1, 2005  | 339,635      | \$84,909 | \$1,664,627        | \$(287,719)           | \$ (99,569)                    |      |
| Stock plans  | 2,096        | 524      | 24,039             | -                     | -                              | 2,   |
| Conversion of EPPICS   | 2,225        | 556      | 24,308             | -                     | -                              |      |
| Dividends on common stock of<br>\$1.00 per share                               | -            | -        | (338,364)          | -                     | -                              |      |
| Shares repurchased   | -            | -        | -                  | -                     | -                              | (18, |
| Net income   | -            | -        | -                  | 202,375               | -                              |      |
| Other comprehensive loss, net<br>of tax and reclassifications<br>adjustments   | -            | -        | -                  | -                     | (23,673)                       |      |
| Balance December 31, 2005  | 343,956      | 85,989   | 1,374,610          | (85,344)              | (123,242)                      | (15, |
| Stock plans  | -            | -        | (5,590)            | -                     | -                              | 1,   |
| Conversion of EPPICS   | -            | -        | (2,296)            | -                     | -                              | 1,   |
| Dividends on common stock of<br>\$0.50 per share                               | -            | -        | (162,773)          | -                     | -                              |      |
| Shares repurchased   | -            | -        | -                  | -                     | -                              | (10, |
| Net income   | -            | -        | -                  | 152,185               | -                              |      |
| Other comprehensive income, net<br>of tax and reclassifications<br>adjustments | -            | -        | -                  | -                     | 10                             |      |
| Balance June 30, 2006  | 343,956      | \$85,989 | \$1,203,951        | \$ 66,841             | \$(123,232)                    | (23, |

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2006 AND 2005  
 (\$ in thousands)  
 (Unaudited)

|   | For the three months ended June 30, |           | For |
|---|-------------------------------------|-----------|-----|
|   | 2006                                | 2005      | 2   |
| Net income  | \$ 101,702                          | \$ 44,584 |     |
| Other comprehensive income (loss), net<br>of tax and reclassifications adjustments* | 2                                   | (268)     |     |
| Total comprehensive income  | \$ 101,704                          | \$ 44,316 |     |

\* Consists of unrealized holding (losses)/gains of marketable securities and for 2005 realized gains taken to income as a result of the sale of

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securities.

The accompanying Notes are an integral part of these  
Consolidated Financial Statements.

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PART I. FINANCIAL INFORMATION (Continued)

CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE SIX MONTHS ENDED JUNE 30, 2006 AND 2005  
(\$ in thousands)  
(Unaudited)

|  | 2006       |
|--|------------|
|  | -----      |
| Cash flows provided by (used in) operating activities:   |            |
| Net income   | \$ 152,185 |
| Deduct: Gain on sale of discontinued operations  | -          |
| Income from discontinued operations  | (13,452)   |
| Adjustments to reconcile income to net cash provided by<br>operating activities:                           |            |
| Depreciation and amortization expense  | 241,556    |
| Gain on expiration/settlement of customer advances   | -          |
| Stock based compensation expense   | 5,335      |
| Loss on debt exchange  | -          |
| Investment gain  | (61,428)   |
| Other non-cash adjustments   | 5,065      |
| Deferred income taxes  | 78,153     |
| Change in accounts receivable  | 7,844      |
| Change in accounts payable and other liabilities   | (37,763)   |
| Change in other current assets   | 2,974      |
|  | -----      |
| Net cash provided by continuing operating activities   | 380,469    |
| Cash flows from investing activities:  |            |
| Proceeds from sales of assets, net of selling expenses   | -          |
| Proceeds from sale of discontinued operations  | -          |
| Securities sold  | -          |
| Capital expenditures   | (98,284)   |
| Other assets (purchased) distributions received, net   | 62,244     |
|  | -----      |
| Net cash used by investing activities  | (36,040)   |
| Cash flows from financing activities:  |            |
| Receipt (repayment) of customer advances for<br>construction and contributions in aid of construction, net | 17         |
| Long-term debt payments  | (198,126)  |
| Issuance of common stock   | 12,756     |
| Common stock repurchased   | (135,239)  |
| Dividends paid   | (162,773)  |
|  | -----      |
| Net cash used by financing activities  | (483,365)  |



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|   |             |
|---|-------------|
| Cash flows of discontinued operations (revised - see Note 5): |             |
| Operating cash flows  | 16,880      |
| Investing cash flows  | (5,545)     |
| Financing cash flows  | -           |
|   | 11,335      |
| (Decrease) increase in cash and cash equivalents              | (127,601)   |
| Cash and cash equivalents at January 1,                       | 268,917     |
|   | -----       |
| Cash and cash equivalents at June 30,                         | \$ 141,316  |
|   | =====       |
| Cash paid during the period for:                              |             |
| Interest  | \$ 169,841  |
| Income taxes  | \$ 2,871    |
| Non-cash investing and financing activities:                  |             |
| Change in fair value of interest rate swaps                   | \$ (15,100) |
| Conversion of EPPICS  | \$ 14,249   |
| Debt-for-debt exchange, net                                   | \$ (70)     |

The accompanying Notes are an integral part of these  
Consolidated Financial Statements.

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### PART I. FINANCIAL INFORMATION (Continued) CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES

(1) Summary of Significant Accounting Policies:

(a) Basis of Presentation and Use of Estimates:

Citizens Communications Company and its subsidiaries are referred to as "we," "us," "our," or the "Company" in this report. Our unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) and should be read in conjunction with the consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2005. Certain reclassifications of balances previously reported have been made to conform to the current presentation. All significant intercompany balances and transactions have been eliminated in consolidation. These unaudited consolidated financial statements include all adjustments, which consist of normal recurring accruals necessary to present fairly the results for the interim periods shown.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions which 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 revenue and expenses during the reporting period. Actual results may differ from those estimates. Estimates and judgments are used when accounting for allowance for doubtful accounts, impairment of long-lived assets, intangible assets, depreciation and amortization, employee benefit plans, income taxes, contingencies and pension and postretirement benefits expenses among others.

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Certain information and footnote disclosures have been excluded and/or condensed pursuant to Securities and Exchange Commission rules and regulations. The results of the interim periods are not necessarily indicative of the results for the full year.

(b) Cash Equivalents:

-----  
We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents.

(c) Revenue Recognition:

-----  
Revenue is recognized when services are provided or when products are delivered to customers. Revenue that is billed in advance includes: monthly recurring network access services, special access services and monthly recurring local line charges. The unearned portion of this revenue is initially deferred as a component of other liabilities on our consolidated balance sheet and recognized in revenue over the period that the services are provided. Revenue that is billed in arrears includes: non-recurring network access services, switched access services, non-recurring local services and long-distance services. The earned but unbilled portion of this revenue is recognized in revenue in our statement of operations and accrued in accounts receivable in the period that the services are provided. Excise taxes are recognized as a liability when billed. Installation fees and their related direct and incremental costs are initially deferred and recognized as revenue and expense over the average term of a customer relationship. We recognize as current period expense the portion of installation costs that exceeds installation fee revenue.

(d) Property, Plant and Equipment:

-----  
Property, plant and equipment are stated at original cost or fair market value for our acquired properties, including capitalized interest. Maintenance and repairs are charged to operating expenses as incurred. The gross book value, of routine property, plant and equipment retired is charged against accumulated depreciation.

(e) Goodwill and Other Intangibles:

-----  
Intangibles represent the excess of purchase price over the fair value of identifiable tangible assets acquired. We undertake studies to determine the fair values of assets and liabilities acquired and allocate purchase prices to assets and liabilities, including property, plant and equipment, goodwill and other identifiable intangibles. We annually (during the fourth quarter) examine the carrying value of our goodwill and trade name to determine whether there are any impairment losses.

Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets," requires that intangible assets (primarily customer base) with estimated useful lives be amortized over those lives and be reviewed for impairment in accordance with SFAS No. 144, "Accounting for Impairment or Disposal of Long-Lived Assets" to determine whether any changes to these lives are required. We periodically reassess the useful life of our intangible assets with

estimated useful lives to determine whether any changes to those lives are required.

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(f) Impairment of Long-Lived Assets and Long-Lived Assets to Be Disposed

-----  
of:

--

We review long-lived assets to be held and used and long-lived assets to be disposed of, including intangible assets with estimated useful lives, for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by comparing the carrying amount of the asset to the future undiscounted net cash flows expected to be generated by the asset. Recoverability of assets held for sale is measured by comparing the carrying amount of the assets to their estimated fair market value. If any assets are considered to be impaired, the impairment is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value.

(g) Derivative Instruments and Hedging Activities:

-----  
We account for derivative instruments and hedging activities in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 133, as amended, requires that all derivative instruments, such as interest rate swaps, be recognized in the financial statements and measured at fair value regardless of the purpose or intent of holding them.

We have interest rate swap arrangements related to a portion of our fixed rate debt. These hedge strategies satisfy the fair value hedging requirements of SFAS No. 133, as amended. As a result, the fair value of the hedges is carried on the balance sheet in other liabilities and the related underlying liabilities are also adjusted to fair value by the same amount.

(h) Stock Plans:

-----  
We have various employee stock-based compensation plans. Awards under these plans are granted to eligible officers, management employees, non-management employees and non-employee directors. Awards may be made in the form of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock or other stock-based awards. We have no awards with market or performance conditions. Our general policy is to issue shares upon the grant of restricted shares and exercise of options from treasury.

On January 1, 2006, we adopted the provisions of SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R") and elected to use the modified prospective transition method. The modified prospective transition method requires that compensation cost be recognized in the financial statements for all awards granted after the date of adoption as well as for existing awards for which the requisite service has not been rendered as of the date of adoption. Estimated compensation cost for awards that are outstanding at the effective date will be recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes. Prior periods have not been restated.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. SFAS 123R-3, "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards." We elected to adopt the alternative transition method provided for calculating the tax effects of share-based compensation pursuant to

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SFAS 123R. The alternative transition method includes a simplified method to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee share-based compensation, which is available to absorb tax deficiencies recognized subsequent to the adoption of SFAS No. 123R.

In accordance with the adoption of SFAS No. 123R, we recorded stock-based compensation expense for the cost of stock options, restricted shares and stock units issued under our stock plans (together, "Stock-Based Awards"). Stock-based compensation expense for the three month period ended June 30, 2006 was \$2,659,000 (\$1,662,000 after tax, or \$0.01 per basic and diluted share of common stock) and \$5,335,000 (\$3,335,000 after tax, or \$0.01 per basic and diluted share of common stock) for the first six months of 2006. The compensation cost recognized is based on awards ultimately expected to vest. SFAS No. 123R requires forfeitures to be estimated and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Prior to the adoption of SFAS No. 123R, we applied Accounting Principles Board Opinion (APB) No. 25 and related interpretations to account for our stock plans resulting in the use of the intrinsic-value based method to value the stock. Under APB 25, we were not required to recognize compensation expense for the cost of stock options issued under the Management Equity Incentive Plan (MEIP), 1996

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Equity Incentive Plan (EIP) and the Amended and Restated 2000 EIP stock plans.

In the past, we provided pro forma net income and pro forma net income per share of common stock disclosures for employee and non-employee director stock option grants based on the fair value of the options at the date of grant. For purposes of presenting pro forma information, the fair value of options granted is computed using the Black-Scholes option-pricing model.

Had we determined compensation cost based on the fair value at the grant date for the MEIP, EIP, Employee Stock Purchase Plan (ESPP) and Non-Employee Directors' Deferred Fee Equity Plan, our pro forma net income and net income per share of common stock available for common stockholders would have been as follows:

|  |             | Three Months Ended<br>June 30, 2005 |
|--|-------------|-------------------------------------|
| -----  |             |                                     |
| (\$ in thousands)  |             |                                     |
| Net income available   |             |                                     |
| for common stockholders  | As reported | \$ 44,584                           |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects           |             | 1,322                               |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net |             |                                     |

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of related tax effects

(2,170)

Pro forma

\$ 43,736

Net income per share of common stock  
available for common stockholders

|  |                 |         |
|--|-----------------|---------|
|  | As<br>reported: |         |
|  | Basic           | \$ 0.13 |
|  | Diluted         | \$ 0.13 |
|  | Pro forma:      |         |
|  | Basic           | \$ 0.13 |
|  | Diluted         | \$ 0.13 |

(i) Net Income Per Share of Common Stock Available for Common  
-----  
Stockholders:  
-----

Basic net income per share of common stock is computed using the weighted average number of shares of common stock outstanding during the period being reported on. Except when the effect would be antidilutive, diluted net income per share of common stock reflects the dilutive effect of the assumed exercise of stock options using the treasury stock method at the beginning of the period being reported on as well as shares of common stock that would result from the conversion of convertible preferred stock (EPPICS). In addition, the related interest on debt (net of tax) is added back to income since it would not be paid if the debt was converted into common stock.

(2) Recent Accounting Literature and Changes in Accounting Principles:  
-----

Accounting for Conditional Asset Retirement Obligations  
-----

In March 2005, the FASB issued FIN 47, "Accounting for Conditional Asset Retirement Obligations," an interpretation of FASB No. 143. FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB No. 143 refers to a legal obligation to perform an asset retirement activity in which the timing or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. Although a liability exists for the removal of poles and asbestos, sufficient information is not available currently to estimate our liability, as the range of time over which we may settle these obligations is unknown or cannot be reasonably estimated. The adoption of FIN 47 during the fourth quarter of 2005 had no impact on our financial position, results of operations or cash flows.

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How Taxes Collected from Customers and Remitted to Governmental Authorities  
-----  
Should be Presented in the Income Statement  
-----

In June 2006, the FASB issued EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement" (EITF 06-3), which requires disclosure of the accounting policy for any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction, that is Gross versus

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Net presentation. EITF 06-3 is effective for periods beginning after December 15, 2006. We do not expect the adoption of EITF 06-3 to have a material impact on our financial position, results of operations or cash flows.

### Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued FASB Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes. Among other things, FIN 48 requires applying a "more likely than not" threshold to the recognition and derecognition of tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN 48 to have a material impact on our financial position, results of operations or cash flows.

### Partnerships

In June 2005, the FASB issued EITF No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," which provides new guidance on how general partners in a limited partnership should determine whether they control a limited partnership. EITF No. 04-5 is effective for fiscal periods beginning after December 15, 2005.

The Company has applied the provisions of EITF No. 04-5 and consolidated the Mohave Cellular Limited Partnership (Mohave) effective January 1, 2006. As permitted, we elected to apply EITF No. 04-5 retrospectively from the date of adoption. We are the managing partner and have a 33% ownership position.

Selected data for the Mohave partnership is as follows:

| (\$ in thousands)    | For the three months<br>ended June 30, |         | For the six months ended<br>June 30, |         |
|----------------------|--|---------|--------------------------------------|---------|
|                      | 2006                                   | 2005    | 2006                                 | 2005    |
| Revenues             | \$4,764                                | \$3,969 | \$9,207                              | \$7,667 |
| Depreciation Expense | 568                                    | 527     | 1,083                                | 1,038   |
| Operating Income     | 1,291                                  | 848     | 2,489                                | 1,544   |

### (3) Accounts Receivable:

The components of accounts receivable, net at June 30, 2006 and December 31, 2005 are as follows:

| (\$ in thousands)                     | June 30, 2006 | December 31, 2005 |
|---------------------------------------|---------------|-------------------|
| End user                              | \$ 228,116    | \$ 210,470        |
| Other                                 | 20,014        | 24,231            |
| Less: Allowance for doubtful accounts | (52,904)      | (31,631)          |
| Accounts receivable, net              | \$ 195,226    | \$ 203,070        |

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The Company maintains an allowance for estimated bad debts based on its estimate of collectibility of its accounts receivables. Bad debt expense, which is recorded as a reduction of revenue, was \$2,806,000 and \$3,943,000 for the three months ended June 30, 2006 and 2005, respectively, and \$7,181,000 and \$6,863,000 for the six months ended June 30, 2006 and 2005, respectively. Our reserve has increased by approximately \$20,000,000 as a result of carrier activity that is in dispute.

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(4) Property, Plant and Equipment, Net:

-----  
Property, plant and equipment at June 30, 2006 and December 31, 2005 is as follows:

| (\$ in thousands)                  | June 30, 2006 | December 31, 2005 |
|------------------------------------|---------------|-------------------|
|                                    | -----         | -----             |
| Property, plant and equipment      | \$ 6,518,509  | \$ 6,433,119      |
| Less: accumulated depreciation     | (3,540,445)   | (3,374,807)       |
|                                    | -----         | -----             |
| Property, plant and equipment, net | \$ 2,978,064  | \$ 3,058,312      |
|                                    | =====         | =====             |

Depreciation expense is principally based on the composite group method. Depreciation expense was \$87,957,000 and \$100,879,000 for the three months ended June 30, 2006 and 2005, respectively, and \$178,366,000 and \$203,378,000 for the six months ended June 30, 2006 and 2005, respectively.

(5) Discontinued Operations:

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In accordance with SFAS No. 144, any component of our business that we dispose of or classify as held for sale that has operations and cash flows clearly distinguishable from operations and for financial reporting purposes, and that will be eliminated from the ongoing operations, should be classified as discontinued operations. Accordingly, we have classified the results of operations of Electric Lightwave, LLC (ELI) and Conference-Call USA, LLC (CCUSA) as discontinued operations in our consolidated statement of operations. All prior periods have been restated. In addition, our statement of cash flows for the six months ended June 30, 2005 has been revised to separately disclose the operating, investing and financing portions of the cash flows attributable to our CCUSA discontinued operations, which in prior periods were reported on a combined basis as a single amount.

ELI

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In February 2006, we entered into a definitive agreement to sell all of the outstanding membership interests in ELI, our competitive local exchange carrier business (CLEC), to Integra Telecom Holdings, Inc. (Integra), for \$247,000,000, including \$243,000,000 in cash plus the assumption of approximately \$4,000,000 in capital lease obligations, subject to customary adjustments under the terms of the agreement. This transaction closed on July 31, 2006. We expect to recognize a pre-tax gain on the sale of ELI of

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approximately \$125,000,000. Our existing tax net operating losses will be used to absorb the potential cash liability for taxes.

ELI had revenues of \$159,200,000 and operating income of \$21,300,000 for the year ended December 31, 2005. At December 31, 2005, ELI's net assets totaled \$116,500,000. We had no outstanding debt specifically identified with ELI and therefore no interest expense was allocated to discontinued operations. We ceased to record depreciation expense effective February 1, 2006.

Summarized financial information for ELI is set forth below:

| (\$ in thousands)                                 | June 30,<br>2006 | December 31,<br>2005 |
|---|------------------|----------------------|
|   | -----            | -----                |
| Current assets                                    | \$ 21,710        | \$ 24,986            |
| Net property, plant and equipment                 | 141,205          | 137,730              |
|   | -----            | -----                |
| Total assets held for sale                        | \$ 162,915       | \$ 162,716           |
|   | =====            | =====                |
| Current liabilities                               | \$ 20,039        | \$ 21,605            |
| Long-term debt                                    | 4,187            | 4,246                |
| Other liabilities                                 | 20,122           | 20,415               |
|   | -----            | -----                |
| Total liabilities related to assets held for sale | \$ 44,348        | \$ 46,266            |
|   | =====            | =====                |

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| (\$ in thousands) | For the three months ended June 30, |           | For the six months ended J |       |
|-------------------|-------------------------------------|-----------|----------------------------|-------|
|                   | 2006                                | 2005      | 2006                       | 2005  |
|                   | -----                               | -----     | -----                      | ----- |
| Revenue           | \$ 43,584                           | \$ 39,027 | \$ 86,078                  |       |
| Operating income  | 11,482                              | 5,231     | 21,940                     |       |
| Income taxes      | 4,526                               | 2,110     | 8,488                      |       |
| Net income        | 6,956                               | 3,121     | 13,452                     |       |

### CCUSA

-----  
 In February 2005, we entered into a definitive agreement to sell CCUSA, our conferencing services business. On March 15, 2005, we completed the sale for \$43,565,000 in cash, subject to adjustments under the terms of the agreement. The pre-tax gain on the sale of CCUSA was \$14,061,000. Our after-tax gain was \$1,167,000. The book income taxes recorded upon sale are primarily attributable to a low tax basis in the assets sold.

We had no outstanding debt specifically identified with CCUSA and therefore no interest expense was allocated to discontinued operations. In addition, we ceased to record depreciation expense effective February 16, 2005.

Summarized financial information for CCUSA is set forth below:



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| (\$ in thousands)                     | For the six months ended June 30, |          |
|---------------------------------------|-----------------------------------|----------|
|                                       | 2006                              | 2005     |
| Revenue                               | \$ -                              | \$ 4,607 |
| Operating income                      | -                                 | 1,489    |
| Income taxes                          | -                                 | 449      |
| Net income                            | -                                 | 1,040    |
| Gain on disposal of CCUSA, net of tax | -                                 | 1,167    |

(6) Other Intangibles:

Other intangibles at June 30, 2006 and December 31, 2005 are as follows:

| (\$ in thousands)                          | June 30, 2006 | December 31, 2005 |
|--|---------------|-------------------|
| Customer base - amortizable over 96 months | \$ 994,605    | \$ 994,605        |
| Trade name - non-amortizable               | 122,058       | 122,058           |
| Other intangibles                          | 1,116,663     | 1,116,663         |
| Accumulated amortization                   | (621,120)     | (557,930)         |
| Total other intangibles, net               | \$ 495,543    | \$ 558,733        |

Amortization expense was \$31,595,000 and \$63,190,000 for the three and six months ended June 30, 2006 and 2005, respectively. Amortization expense, based on our estimate of useful lives, is estimated to be \$126,380,000 per year through 2008 and \$57,533,000 in 2009, at which point these assets will have been fully amortized.

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(7) Long-Term Debt:

The activity in our long-term debt from December 31, 2005 to June 30, 2006 is as follows:

| (\$ in thousands)            | Six Months Ended June 30, 2006 |          |                    |                  |
|------------------------------|--------------------------------|----------|--------------------|------------------|
|                              | December 31, 2005              | Payments | Interest Rate Swap | Reclassification |
| FIXED RATE                   |                                |          |                    |                  |
| Rural Utilities Service Loan |                                |          |                    |                  |
| Contracts                    | \$ 22,809                      | \$ (469) | \$ -               | \$ -             |

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|                                      |              |              |             |             |
|--------------------------------------|--------------|--------------|-------------|-------------|
| Senior Unsecured Debt                | 4,120,781    | (197,657)    | (15,100)    | (70)        |
| EPPICS                               | 33,785       | -            | -           | (14,249)    |
| Industrial Development Revenue Bonds | 58,140       | -            | -           | -           |
| TOTAL LONG TERM DEBT                 | 4,235,515    | \$ (198,126) | \$ (15,100) | \$ (14,319) |
| Less: Debt Discount                  | (12,692)     |              |             |             |
| Less: Current Portion                | (227,693)    |              |             |             |
|                                      | \$ 3,995,130 |              |             |             |

\* Interest rate includes amortization of debt issuance costs, debt premiums or discounts. The interest rate for Rural Utilities Service Loan Contracts, Senior Unsecured Debt, and Industrial Development Revenue Bonds represent a weighted average of multiple issuances.

In February 2006, our Board of Directors authorized us to repurchase up to \$150,000,000 of our outstanding debt over the following twelve-month period. These repurchases may require us to pay premiums, which would result in pre-tax losses to be recorded in investment and other income (loss).

For the six months ended June 30, 2006, we retired an aggregate principal amount of \$212,445,000 of debt, including \$14,249,000 of 5% Company Obligated Mandatorily Redeemable Convertible Preferred Securities due 2036 (EPPICS) that were converted into our common stock. During the first quarter of 2006, we entered into two debt-for-debt exchanges of our debt securities. As a result, \$47,500,000 of our 7.625% notes due 2008 were exchanged for approximately \$47,430,000 of our 9.00% notes due 2031. The 9.00% notes are callable on the same general terms and conditions as the 7.625% notes that were exchanged. No cash was exchanged in these transactions, however a non-cash pre-tax loss of approximately \$2,392,000 was recognized in accordance with EITF No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," which is included in other income (loss), net.

As of June 30, 2006, EPPICS representing a total principal amount of \$192,200,000 have been converted into 15,480,799 shares of our common stock. Approximately \$9,030,000 of EPPICS, which are convertible into 787,661 shares of our common stock, were outstanding at June 30, 2006.

The total outstanding principal amounts of industrial development revenue bonds were \$58,140,000 at June 30, 2006 and December 31, 2005. The earliest maturity date for these bonds is in August 2015. Under the terms of our agreements to sell our former gas and electric operations in Arizona, completed in 2003, we are obligated to call for redemption, at their first available call dates, three Arizona industrial development revenue bond series aggregating to approximately \$33,440,000. The first call dates for these bonds are in 2007. We expect to retire all called bonds with cash. In addition, holders of \$11,150,000 principal amount of industrial development bonds may tender such bonds to us at par and we have the simultaneous option to call such bonds at par on August 1, 2007. We expect to call the bonds and retire them with cash.

As of June 30, 2006, we have available lines of credit with financial institutions in the aggregate amount of \$250,000,000. Associated facility fees vary, depending on our debt leverage ratio, and are 0.375% per annum

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as of June 30, 2006. The expiration date for the facility is October 29, 2009. During the term of the facility we may borrow, repay and reborrow funds. The credit facility is available for general corporate purposes but may not be used to fund dividend payments. There have never been any borrowings under the facility.

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(8) Net Income Per Share of Common Stock:

The reconciliation of the income per share of common stock calculation for the three and six months ended June 30, 2006 and 2005, respectively, is as follows:

| (\$ in thousands, except per-share amounts)               | For the three months ended June 30, |           | For the six months ended June 30, |
|---|-------------------------------------|-----------|-----------------------------------|
|   | 2006                                | 2005      |                                   |
| Net income used for basic and diluted earnings            |                                     |           |                                   |
| per share of common stock:                                |                                     |           |                                   |
| Income from continuing operations                         | \$ 94,746                           | \$ 41,463 | \$ 130,209                        |
| Income from discontinued operations                       | 6,956                               | 3,121     | 1,121                             |
| Total basic net income available to common stockholders   | \$ 101,702                          | \$ 44,584 | \$ 131,330                        |
| Effect of conversion of preferred securities - EPPICS     | 79                                  | -         | -                                 |
| Total diluted net income available to common stockholders | \$ 101,781                          | \$ 44,584 | \$ 131,330                        |
| Basic earnings per share of common stock:                 |                                     |           |                                   |
| Weighted-average common stock outstanding - basic         | 322,337                             | 340,389   | 322,337                           |
| Income from continuing operations                         | \$ 0.30                             | \$ 0.12   | \$ 0.40                           |
| Income from discontinued operations                       | 0.02                                | 0.01      | 0.03                              |
| Net income per share available to common stockholders     | \$ 0.32                             | \$ 0.13   | \$ 0.43                           |
| Diluted earnings per share of common stock:               |                                     |           |                                   |
| Weighted-average common stock outstanding                 | 322,337                             | 340,389   | 322,337                           |
| Effect of dilutive shares                                 | 698                                 | 3,252     | 698                               |
| Effect of conversion of preferred securities - EPPICS     | 847                                 | -         | -                                 |
| Weighted-average common stock outstanding - diluted       | 323,882                             | 343,641   | 323,035                           |
| Income from continuing operations                         | \$ 0.29                             | \$ 0.12   | \$ 0.39                           |
| Income from discontinued operations                       | 0.02                                | 0.01      | 0.03                              |
| Net income per share available to common stockholders     | \$ 0.31                             | \$ 0.13   | \$ 0.42                           |

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### Stock Options

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For the three and six months ended June 30, 2006, options to purchase 1,960,000 shares at exercise prices ranging from \$13.03 to \$18.46 issuable under employee compensation plans were excluded from the computation of diluted earning per share of common stock for those periods because the exercise prices were greater than the average market price of our common stock and, therefore, the effect would be antidilutive.

For the three and six months ended June 30, 2005, options to purchase 2,521,000 and 2,501,000 shares, respectively, at exercise prices ranging from \$13.03 to \$18.46 issuable under employee compensation plans were excluded from the computation of diluted EPS for those periods because the exercise prices were greater than the average market price of common shares and, therefore, the effect would be antidilutive.

In addition, for the three and six months ended June 30, 2006 and 2005, restricted stock awards of 1,212,000 and 1,477,000 shares, respectively, are excluded from our basic weighted average shares of common stock outstanding and included in our dilutive shares of common stock using the treasury stock method until the shares are no longer contingent upon the satisfaction of all specified conditions.

### EPPICS

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As a result of our July 2004 dividend announcement with respect to our common stock, our EPPICS began to convert into shares of our common stock. As of June 30, 2006, approximately 96% of the EPPICS outstanding, or about \$192,200,000 aggregate principal amount of EPPICS, have converted into 15,480,799 shares of our common stock, including 2,358,549 shares issued from treasury.

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At June 30, 2006, we had 180,594 shares of potentially dilutive EPPICS, which were convertible into our common stock at a 4.36 to 1 ratio at an exercise price of \$11.46 per share. If all remaining EPPICS are converted we would issue approximately 787,661 shares of our common stock. These securities have been included in the diluted income per share of common stock calculation for the period ended June 30, 2006.

At June 30, 2005, we had 554,938 shares of potentially dilutive EPPICS, which were convertible into our common stock at a 4.36 to 1 ratio at an exercise price of \$11.46 per share. These securities have not been included in the diluted income per share of common stock calculation for the period ended June 30, 2005 because their inclusion would have had an antidilutive effect.

### Stock Units

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At June 30, 2006 and 2005, we had 282,000 and 201,000 stock units, respectively, issued under our Non-Employee Directors' Deferred Fee Equity Plan ("Deferred Fee Plan") Non-employee Directors' Equity Incentive Plan ("Directors' Equity Plan") and Non-Employee Directors' Retirement Plan. These securities have not been included in the diluted income per share of common stock calculation because their inclusion would have had an antidilutive effect.

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### (9) Stock Plans:

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At June 30, 2006, we have five stock-based compensation plans, which are described below. Prior to the adoption of SFAS No. 123R, we applied APB No. 25 and related interpretations to account for our stock plans resulting in the use of the intrinsic value to value the stock and determine compensation expense. Under APB 25, we were not required to recognize compensation expense for the cost of stock options. In accordance with the adoption of SFAS 123R, we recorded stock-based compensation expense for the cost of stock options, restricted shares and stock units issued pursuant to the Management Equity Incentive Plan (MEIP), the 1996 Equity Incentive Plan (1996 EIP), the Amended and Restated 2000 Equity Incentive Plan (2000 EIP), the Deferred Fee plan and the Directors' Equity Plan. Our general policy is to issue shares upon the grant of restricted shares and exercise of options from treasury. At June 30, 2006, there were 29,841,523 shares authorized for grant under these plans and 5,802,592 shares available for grant.

#### Management Equity Incentive Plan

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Under the MEIP, awards of our common stock were granted to eligible officers, management employees and non-management employees in the form of incentive stock options, non-qualified stock options, stock appreciation rights (SARs), restricted stock or other stock-based awards.

Since the expiration date of the MEIP plan on June 21, 2000, no awards can be granted under the MEIP. The exercise price of stock options issued was equal to or greater than the fair market value of the underlying common stock on the date of grant. Stock options are not ordinarily exercisable on the date of grant but vest over a period of time (generally 4 years). Under the terms of the MEIP, subsequent stock dividends and stock splits have the effect of increasing the option shares outstanding, which correspondingly decreases the average exercise price of outstanding options.

#### Equity Incentive Plans

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Since the expiration date of the 1996 EIP on May 22, 2006, no awards can be granted under the 1996 EIP. Under the 2000 EIP awards of our common stock may be granted to eligible officers, management employees and non-management employees in the form of incentive stock options, non-qualified stock options, SARs, restricted stock or other stock-based awards. As discussed under the Non-Employee Directors' Compensation Plans below, prior to May 25, 2006 directors received an award of stock options under the 2000 EIP upon commencement of service.

At June 30, 2006, there were 27,389,711 shares authorized for grant under the 2000 EIP and 3,368,375 shares available for grant, as adjusted to reflect stock dividends. No awards will be granted more than 10 years after the effective date (May 18, 2000) of the 2000 EIP plan. The exercise price of stock options and SARs under the 2000 and 1996 EIP generally shall be equal to or greater than the fair market value of the underlying common stock on the date of grant. Stock options are not ordinarily exercisable on the date of grant but vest over a period of time (generally 4 years).

Under the terms of the EIP plans, subsequent stock dividends and stock splits have the effect of increasing the option shares outstanding, which correspondingly decrease the average exercise price of outstanding options.

The following summary presents information regarding outstanding stock

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options as of June 30, 2006 and changes during the six months then ended with regard to options under the MEIP and EIP plans:

|                                       | Shares<br>Subject to<br>Option | Weighted<br>Average<br>Option Price<br>Per Share | Weighted<br>Average<br>Remaini<br>Life in Y |
|---------------------------------------|--------------------------------|--|---|
| Balance at January 1, 2006            | 7,985,000                      | \$11.52  |   |
| Options granted                       | 13,000                         | 12.11  |   |
| Options exercised                     | (1,309,000)                    | 9.67   |   |
| Options canceled, forfeited or lapsed | (55,000)                       | 9.88   |   |
| -----                                 |                                |  |   |
| Balance at June 30, 2006              | 6,634,000                      | 11.90  | 4.96  |
| =====                                 |                                |  |   |
| Exercisable at June 30, 2006          | 6,162,000                      | \$12.00  | 4.79  |
| =====                                 |                                |  |   |

Options granted during the first six months of 2006 totaled 13,000. The weighted average grant-date fair value of options granted during the six months ended June 30, 2006 was \$3.08. Cash received upon the exercise of options during the first six months of 2006 totaled \$12,756,000. Total remaining unrecognized compensation cost associated with unvested stock options at June 30, 2006 was \$1,632,000 and the weighted average period over which this cost is expected to be recognized is approximately one year.

The total intrinsic value of stock options exercised during the first six months of 2005 was \$6,996,000. The total intrinsic value of stock options outstanding and exercisable at June 30, 2005 was \$26,554,000 and \$21,095,000, respectively. The weighted average grant-date fair value of options granted during the six months ended June 30, 2005 was \$3.03. Options granted during the first six months of 2005 totaled 50,000. Cash received upon the exercise of options during the first six months of 2005 totaled \$24,953,000.

For purposes of determining compensation expense, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model which requires the use of various assumptions including: expected life of the option; expected dividend rate; expected volatility; and risk-free interest rate. The expected life (estimated period of time outstanding) of stock options granted was estimated using the historical exercise behavior of employees. The risk free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatility is based on historical volatility for a period equal to the stock option's expected life, calculated on a monthly basis.

The following table presents the weighted average assumptions used for grants in the first six months of 2006:

|                         | 2006    |
|-------------------------|---------|
| Dividend yield          | 7.55%   |
| Expected volatility     | 44%     |
| Risk-free interest rate | 4.89%   |
| Expected life           | 5 years |

The following table presents the weighted average assumptions used for

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grants in fiscal 2005:

|                         | 2005    |
|-------------------------|---------|
| Dividend yield          | 7.72%   |
| Expected volatility     | 46%     |
| Risk-free interest rate | 4.16%   |
| Expected life           | 6 years |

The following summary presents information regarding unvested restricted stock as of June 30, 2006 and changes during the six months then ended with regard to restricted stock under the MEIP and EIP plans:

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|                             | Number of<br>Shares | Weighted<br>Average<br>Grant Date<br>Fair Value | Aggregate<br>Fair Value at<br>June 30, 2006 |
|-----------------------------|---------------------|---|---|
| Unvested at January 1, 2006 | 1,456,000           | \$12.47   |   |
| Granted                     | 730,000             | 12.86   | \$9,530,000                                 |
| Vested                      | (602,000)           | 12.00   | \$7,581,000                                 |
| Forfeited                   | (372,000)           | 12.60   |   |
| Unvested at June 30, 2006   | 1,212,000           | \$12.90   | \$15,820,000                                |

For purposes of determining compensation expense, the fair value of each restricted stock grant is estimated based on the average of the high and low market price of a share of our common stock on the date of grant. Total remaining unrecognized compensation cost associated with unvested restricted stock awards at June 30, 2006 was \$13,179,000 and the weighted average period over which this cost is expected to be recognized is approximately three years.

The total fair value of shares granted and vested during the six months ended June 30, 2005 was approximately \$4,240,000 and \$6,119,000, respectively. The total fair value of unvested restricted stock at June 30, 2005 was \$19,856,000. The weighted average grant-date fair value of restricted shares granted during the six months ended June 30, 2005 was \$13.10. Shares granted during the first six months of 2005 totaled 316,000.

### Non-Employee Directors' Compensation Plans

Each non-employee director receives a grant of 10,000 stock options upon commencement of his or her service on the Board of Directors. These options are currently awarded under the Directors' Equity Plan. Prior to effectiveness of the Directors' Equity Plan on May 25, 2006, these options were awarded under the 2000 EIP. The exercise price of these options, which become exercisable six months after the grant date, is the fair market value (as defined in the relevant plan) of our common stock on the date of grant. Options granted under the Directors' Equity Plan expire on the earlier of the tenth anniversary of the grant date or the first anniversary of termination of service as a director.

Each non-employee director also receives an annual grant of 3,500 stock units. These units are currently awarded under the Directors' Equity Plan

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and prior to effectiveness of that plan, were awarded under the Deferred Fee Plan. Each non-employee director may also elect to receive meeting fees and, when applicable, fees for serving as a committee chair and/or Lead Director, in stock units. In addition, non-employee directors may also elect to receive stock units in lieu of the annual cash retainer. Stock units are payable upon termination of service as a director in either common stock (convertible on a one-to-one basis) or cash, at the election of the director.

Upon effectiveness of the Directors' Equity Plan, no further grants will be made under the Deferred Fee Plan.

The number of shares of common stock authorized for issuance under the Directors' Equity Plan is 2,451,812, which includes 451,812 shares available for grant under the Deferred Fee Plan on the effective date of the Directors' Equity Plan. In addition, if and to the extent that any "plan units" outstanding on May 25, 2006 under the Deferred Fee Plan are forfeited, or if any option granted under the Deferred Fee Plan terminates, expires, or is cancelled or forfeited, without having been fully exercised, shares of common stock subject to such "plan units" or options cancelled shall become available under the Directors' Equity Plan. At June 30, 2006, there were 2,434,217 shares available for grant. There were 12 directors participating in the non-employee plans during the second quarter of 2006. In the first six months of 2006, total plan units earned were 75,493. At June 30, 2006, 289,587 options were exercisable at a weighted average exercise price of \$10.40.

We account for the Deferred Fee Plan in accordance with SFAS No. 123R. If cash is elected, it is considered a liability-based award. If stock units are elected, they are considered equity-based awards. Compensation expense for stock units is based on the market value of our common stock at the date of grant. For awards granted prior to 1999, a director could elect to be paid in stock options. Generally, compensation cost was not recorded because the options were granted at the fair market value of our common stock on the grant date under APB No. 25 and related interpretations.

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We had also maintained a Non-Employee Directors' Retirement Plan providing for the payment of specified sums annually to our non-employee directors, or their designated beneficiaries, starting at the director's retirement, death or termination of directorship. In 1999, we terminated this Plan. The vested benefit of each non-employee director, as of May 31, 1999, was credited to the director's account in the form of stock units. Such benefit will be payable to each director upon retirement, death or termination of directorship. Each participant had until July 15, 1999 to elect whether the value of the stock units awarded would be payable in our common stock (convertible on a one-for-one basis) or in cash. As of June 30, 2006, the liability for such payments was approximately \$654,000 all of which will be payable in stock (based on the July 15, 1999 stock price).

### (10) Segment Information:

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As of January 1, 2006, we operate in a single segment, Frontier. Frontier provides both regulated and unregulated communications services to residential, business and wholesale customers and is typically the incumbent provider in its service areas.

As permitted by SFAS No. 131, we have utilized the aggregation criteria in combining our markets because all of the Company's Frontier properties



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share similar economic characteristics: they provide the same products and services to similar customers using comparable technologies in all the states we operate. The regulatory structure is generally similar. Differences in the regulatory regime of a particular state do not materially impact the economic characteristics or operating results of a particular property.

### (11) Derivative Instruments and Hedging Activities:

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Interest rate swap agreements are used to hedge a portion of our debt that is subject to fixed interest rates. Under our interest rate swap agreements, we agree to pay an amount equal to a specified variable rate of interest times a notional principal amount, and to receive in return an amount equal to a specified fixed rate of interest times the same notional principal amount. The notional amounts of the contracts are not exchanged. No other cash payments are made unless the agreement is terminated prior to maturity, in which case the amount paid or received in settlement is established by agreement at the time of termination and represents the market value, at the then current rate of interest, of the remaining obligations to exchange payments under the terms of the contracts.

The interest rate swap contracts are reflected at fair value in our consolidated balance sheet and the related portion of fixed-rate debt being hedged is reflected at an amount equal to the sum of its book value and an amount representing the change in fair value of the debt obligations attributable to the interest rate risk being hedged. The notional amounts of fixed-rate indebtedness hedged as of June 30, 2006 and December 31, 2005 was \$550,000,000 and \$500,000,000, respectively. Such contracts require us to pay variable rates of interest (estimated average pay rates of approximately 9.17% as of June 30, 2006 and approximately 8.60% as of December 31, 2005) and receive fixed rates of interest (average receive rates of 8.26% as of June 30, 2006 and 8.46% as of December 31, 2005, respectively). The fair value of these derivatives is reflected in other liabilities as of June 30, 2006 and December 31, 2005, in the amount of \$23,827,000 and \$8,727,000, respectively. The related underlying debt has been decreased by a like amount. The amounts paid during the three and six months ended June 30, 2006 as a result of these contracts amounted to \$1,134,000 and \$1,668,000 and are included as interest expense.

During September 2005, we entered into a series of separate forward rate agreements with our swap counter-parties that fixed the underlying variable rate component of some of our swaps at the market rate as of the date of execution for certain future rate-setting dates. These agreements have expired. Fair value at December 31, 2005, was \$1,129,000. A gain for the changes in the fair value of these forward rate agreements of \$46,000 and \$430,000, respectively, is included in other income (loss), net for the three and six months ended June 30, 2006.

We do not anticipate any nonperformance by counterparties to our derivative contracts as all counterparties have investment grade credit ratings.

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### (12) Investment and Other Income (Loss), Net:

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The components of investment and other income (loss), net are as follows:

For the three months  
ended June 30,

For

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| (\$ in thousands)                                    | 2006             | 2005          | 2004            |
|--|------------------|---------------|-----------------|
| Investment income                                    | \$ 4,440         | \$ 3,925      | \$ 6,142        |
| Gain from Rural Telephone Bank dissolution           | 61,428           | -             | -               |
| Loss on exchange of debt                             | -                | (3,175)       | -               |
| Investment gain                                      | -                | 395           | -               |
| Other, net   | (505)            | (572)         | -               |
| <b>Total investment and other income (loss), net</b> | <b>\$ 65,363</b> | <b>\$ 573</b> | <b>\$ 6,142</b> |

The gain of \$61,428,000 resulted from the dissolution and liquidation of the Rural Telephone Bank.

(13) Company Obligated Mandatorily Redeemable Convertible Preferred Securities:

In 1996, our consolidated wholly owned subsidiary, Citizens Utilities Trust (the Trust), issued, in an underwritten public offering, 4,025,000 shares of EPPICS, representing preferred undivided interests in the assets of the Trust, with a liquidation preference of \$50 per security (for a total liquidation amount of \$201,250,000). These securities have an adjusted conversion price of \$11.46 per share of our common stock. The conversion price was reduced from \$13.30 to \$11.46 during the third quarter of 2004 as a result of the \$2.00 per share of common stock special, non-recurring dividend. The proceeds from the issuance of the Trust Convertible Preferred Securities and a Company capital contribution were used to purchase \$207,475,000 aggregate liquidation amount of 5% Partnership Convertible Preferred Securities due 2036 from another wholly owned subsidiary, Citizens Utilities Capital L.P. (the Partnership). The proceeds from the issuance of the Partnership Convertible Preferred Securities and a Company capital contribution were used to purchase from us \$211,756,000 aggregate principal amount of 5% Convertible Subordinated Debentures due 2036. The sole assets of the Trust are the Partnership Convertible Preferred Securities, and our Convertible Subordinated Debentures are substantially all the assets of the Partnership. Our obligations under the agreements related to the issuances of such securities, taken together, constitute a full and unconditional guarantee by us of the Trust's obligations relating to the Trust Convertible Preferred Securities and the Partnership's obligations relating to the Partnership Convertible Preferred Securities.

In accordance with the terms of the issuances, we paid the annual 5% interest in quarterly installments on the Convertible Subordinated Debentures in the first and second quarters of 2006 and the four quarters of 2005. Only cash was paid (net of investment returns) to the Partnership in payment of the interest on the Convertible Subordinated Debentures. The cash was then distributed by the Partnership to the Trust and then by the Trust to the holders of the EPPICS.

As of June 30, 2006, EPPICS representing a total principal amount of \$192,200,000 have been converted into 15,480,799 shares of our common stock. A total of \$9,030,000 of EPPICS is outstanding as of June 30, 2006 and if all outstanding EPPICS were converted, 787,661 shares of our common stock would be issued upon such conversion.

(14) Retirement Plans:

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 The following table provides the components of net periodic benefit cost:

|  | Pension Benefits                       |          |       |
|--|--|----------|-------|
|  | For the three months ended<br>June 30, |          | For   |
|  | 2006                                   | 2005     | 2005  |
| -----  |  |          |       |
| (\$ in thousands)  |  |          |       |
| Components of net periodic benefit cost                            |  |          |       |
| -----  |  |          |       |
| Service cost   | \$ 1,759                               | \$ 1,584 | \$    |
| Interest cost on projected benefit obligation                      | 11,504                                 | 11,338   |       |
| Return on plan assets  | (15,126)                               | (15,795) |       |
| Amortization of prior service cost and unrecognized net obligation | (61)                                   | (61)     |       |
| Amortization of unrecognized loss                                  | 3,085                                  | 2,136    |       |
|  | -----                                  |          | ----- |
| Net periodic benefit cost  | \$ 1,161                               | \$ (798) | \$    |
|  | =====                                  |          | ===== |

|  | Other Postretirement                   |          |       |
|--|--|----------|-------|
|  | For the three months ended<br>June 30, |          | For   |
|  | 2006                                   | 2005     | 2005  |
| -----  |  |          |       |
| (\$ in thousands)  |  |          |       |
| Components of net periodic benefit cost                            |  |          |       |
| -----  |  |          |       |
| Service cost   | \$ 174                                 | \$ 314   | \$    |
| Interest cost on projected benefit obligation                      | 2,211                                  | 3,128    |       |
| Return on plan assets  | (245)                                  | (59)     |       |
| Amortization of prior service cost and unrecognized net obligation | (1,026)                                | (158)    |       |
| Amortization of unrecognized loss                                  | 1,513                                  | 2,173    |       |
|  | -----                                  |          | ----- |
| Net periodic benefit cost  | \$ 2,627                               | \$ 5,398 | \$    |
|  | =====                                  |          | ===== |

We expect that our pension and other postretirement benefit expenses for 2006 will be \$15,000,000 - \$18,000,000 (down from \$19,000,000 in 2005) and no contribution will be required to be made by us to the pension plan in 2006.

(15) Related Party Transaction:

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 In June 2005, the Company sold for cash its interests in certain key man life insurance policies on the lives of Leonard Tow, our former Chairman and Chief Executive Officer, and his wife, a former director. The cash surrender value of the policies purchased by Dr. Tow totaled approximately \$24,195,000, and we recognized a gain of approximately \$457,000 that is included in investment and other income.

(16) Commitments and Contingencies:

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 We anticipate capital expenditures of approximately \$270,000,000 - \$280,000,000 for 2006. Although we from time to time make short-term

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purchasing commitments to vendors with respect to these expenditures, we generally do not enter into firm, written contracts for such activities.

The City of Bangor, Maine, filed suit against us on November 22, 2002, in the U.S. District Court for the District of Maine (City of Bangor v. Citizens Communications Company, Civ. Action No. 02-183-B-S). The City alleged, among other things, that we are responsible for the costs of cleaning up environmental contamination alleged to have resulted from the operation of a manufactured gas plant owned by Bangor Gas Company from 1852-1948 and by us from 1948-1963. In acquiring the operation in 1948 we acquired the stock of Bangor Gas Company and merged it into us. The City alleged the existence of extensive contamination of the Penobscot River and initially asserted that money damages and other relief at issue in the lawsuit could exceed \$50,000,000. The City also requested that punitive damages be assessed against us. We filed an answer denying liability to the City, and asserted a number of counterclaims against the City. In addition, we identified a number of other potentially responsible parties that may be liable for the damages alleged by the City and joined them as parties to the lawsuit. These additional parties include UGI Utilities, Inc. and Centerpoint Energy Resources Corporation. The Court dismissed all but two of the City's claims, including its claims for joint and several liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the claim against us for punitive damages.

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On June 27, 2006, the court issued Findings of Fact and Conclusions of Law in the first phase of the case. The court found contamination in only a small section of the River and determined that Citizens and the City should share cleanup costs 60% and 40%, respectively. The precise nature of the remedy in this case remains to be determined by subsequent proceedings. However, based upon the Court's ruling, we believe that we will be responsible for only a portion of the cost to clean up and the final resolution of this matter will not be material to the operating results nor the financial condition of the Company.

Prior to the next phase of the litigation, we intend to (i) seek relief from the Court in connection with the adverse aspects of the Court's opinion and (ii) continue pursuing our right to obtain contribution from the third parties against whom we have commenced litigation in connection with this case. In addition, we have demanded that various of our insurance carriers defend and indemnify us with respect to the City's lawsuit, and on December 26, 2002, we filed a declaratory judgment action against those insurance carriers in the Superior Court of Penobscot County, Maine, for the purpose of establishing their obligations to us with respect to the City's lawsuit. We intend to vigorously pursue this lawsuit and to obtain from our insurance carriers indemnification for any damages that may be assessed against us in the City's lawsuit as well as to recover the costs of our defense of that lawsuit. We cannot at this time determine what amount we may recover from third parties or insurance carriers.

On June 7, 2004, representatives of Robert A. Katz Technology Licensing, LP, contacted us regarding possible infringement of several patents held by that firm. The patents cover a wide range of operations in which telephony is supported by computers, including obtaining information from databases via telephone, interactive telephone transactions, and customer and technical support applications. We were cooperating with the patent holder to determine if we are currently using any of the processes that are protected by its patents but we have not had any communication with them on this issue since mid-2004. If we determine that we are utilizing the patent holder's intellectual property, we expect to commence negotiations on a

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license agreement.

On June 24, 2004, one of our subsidiaries, Frontier Subsidiary Telco, Inc., received a "Notice of Indemnity Claim" from Citibank, N.A., that is related to a complaint pending against Citibank and others in the U.S. Bankruptcy Court for the Southern District of New York as part of the Global Crossing bankruptcy proceeding. Citibank bases its claim for indemnity on the provisions of a credit agreement that was entered into in October 2000 between Citibank and our subsidiary. We purchased Frontier Subsidiary Telco, Inc., in June 2001 as part of our acquisition of the Frontier telephone companies. The complaint against Citibank, for which it seeks indemnification, alleges that the seller improperly used a portion of the proceeds from the Frontier transaction to pay off the Citibank credit agreement, thereby defrauding certain debt holders of Global Crossing North America Inc. Although the credit agreement was paid off at the closing of the Frontier transaction, Citibank claims the indemnification obligation survives. Damages sought against Citibank and its co-defendants could exceed \$1,000,000,000. In August 2004, we notified Citibank by letter that we believe its claims for indemnification are invalid and are not supported by applicable law. We have received no further communications from Citibank since our August 2004 letter.

We are party to other legal proceedings arising in the normal course of our business. The outcome of individual matters is not predictable. However, we believe that the ultimate resolution of all such matters, after considering insurance coverage, will not have a material adverse effect on our financial position, results of operations, or our cash flows.

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The Company sold all of its utility businesses as of April 1, 2004. However, we have retained a potential payment obligation associated with our previous electric utility activities in the state of Vermont. The Vermont Joint Owners (VJO), a consortium of 14 Vermont utilities, including us, entered into a purchase power agreement with Hydro-Quebec in 1987. The agreement contains "step-up" provisions that state that if any VJO member defaults on its purchase obligation under the contract to purchase power from Hydro-Quebec the other VJO participants will assume responsibility for the defaulting party's share on a pro-rata basis. Our pro-rata share of the purchase power obligation is 10%. If any member of the VJO defaults on its obligations under the Hydro-Quebec agreement, then the remaining members of the VJO, including us, may be required to pay for a substantially larger share of the VJO's total power purchase obligation for the remainder of the agreement (which runs through 2015). Paragraph 13 of FIN 45 requires that we disclose, "the maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee." Paragraph 13 also states that we must make such disclosure "... even if the likelihood of the guarantor's having to make any payments under the guarantee is remote...". As noted above, our obligation only arises as a result of default by another VJO member such as upon bankruptcy. Therefore, to satisfy the "maximum potential amount" disclosure requirement we must assume that all members of the VJO simultaneously default, a highly unlikely scenario given that the two members of the VJO that have the largest potential payment obligations are publicly traded with credit ratings equal or superior to ours, and that all VJO members are regulated utility providers with regulated cost recovery. Regardless, despite the remote chance that such an event could occur, or that the State of Vermont could or would allow such an event, assuming that all the members of the VJO defaulted on January 1, 2007 and remained in default for the duration of the contract (another 10 years), we estimate that our undiscounted

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purchase obligation for 2007 through 2015 would be approximately \$1,264,000,000. In such a scenario the Company would then own the power and could seek to recover its costs. We would do this by seeking to recover our costs from the defaulting members and/or reselling the power to other utility providers or the northeast power grid. There is an active market for the sale of power. We could potentially lose money if we were unable to sell the power at cost. We caution that we cannot predict with any degree of certainty any potential outcome.

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### Item 2. Management's Discussion and Analysis of Financial Condition and Results ----- of Operations -----

#### Forward-Looking Statements -----

This quarterly report on Form 10-Q contains forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those expressed or implied in the statements. Statements that are not historical facts are forward-looking statements made pursuant to the Safe Harbor Provisions of the Litigation Reform Act of 1995. Words such as "believes," "anticipates," "expects" and similar expressions are intended to identify forward-looking statements. Forward-looking statements (including oral representations) are only predictions or statements of current plans, which we review continuously. Forward-looking statements may differ from actual future results due to, but not limited to, and our future results may be materially affected by, any of the following possibilities:

- \* Changes in the number of our revenue generating units, which consists of access lines plus high-speed internet subscribers;
- \* The effects of competition from wireless, other wireline carriers (through voice over internet protocol (VOIP) or otherwise), high speed cable modems and cable telephony;
- \* The effects of greater than anticipated competition requiring new pricing, marketing strategies or new product offerings and the risk that we will not respond on a timely or profitable basis;
- \* The effects of general and local economic and employment conditions on our revenues;
- \* Our ability to effectively manage our operations, costs, capital spending, regulatory compliance and service quality;
- \* Our ability to successfully introduce new product offerings including our ability to offer bundled service packages on terms that are both profitable to us and attractive to our customers;
- \* Our ability to sell enhanced and data services in order to offset ongoing declines in revenue from local services, switched access services and subsidies;
- \* Changes in accounting policies or practices adopted voluntarily or as required by generally accepted accounting principles or regulators;
- \* The effects of changes in regulation in the communications industry as a result of federal and state legislation and regulation, including

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potential changes in access charges and subsidy payments, and regulatory network upgrade and reliability requirements;

- \* Our ability to comply with federal and state regulation (including state rate of return limitations on our earnings) and our ability to successfully renegotiate state regulatory plans as they expire or come up for renewal from time to time;
- \* Our ability to manage our operating expenses, capital expenditures, pay dividends and reduce or refinance our debt;
- \* Adverse changes in the ratings given to our debt securities by nationally accredited ratings organizations, which could limit or restrict the availability, and/or increase the cost of financing;
- \* The effects of bankruptcies in the telecommunications industry which could result in more price competition and potential bad debts;
- \* The effects of technological changes and competition on our capital expenditures and product and service offerings, including the lack of assurance that our ongoing network improvements will be sufficient to meet or exceed the capabilities and quality of competing networks;

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- \* The effects of increased medical, retiree and pension expenses and related funding requirements;
- \* Changes in income tax rates, tax laws, regulations or rulings, and/or federal or state tax assessments;
- \* The effects of state regulatory cash management policies on our ability to transfer cash among our subsidiaries and to the parent company;
- \* Our ability to successfully renegotiate expiring union contracts covering approximately 1,045 employees that are scheduled to expire during the remainder of 2006;
- \* Our ability to pay a \$1.00 per common share dividend annually may be affected by our cash flow from operations, amount of capital expenditures, debt service requirements, cash paid for income taxes (which will increase in the future) and our liquidity;
- \* The effects of any future liabilities or compliance costs in connection with worker health and safety matters;
- \* The effects of any unfavorable outcome with respect to any of our current or future legal, governmental, or regulatory proceedings, audits or disputes; and
- \* The effects of more general factors, including changes in economic, business and industry conditions.

Any of the foregoing events, or other events, could cause financial information to vary from management's forward-looking statements included in this report. You should consider these important factors, as well as the risks set forth under Item 1A. "Risk Factors," in our 10-K in evaluating any statement in this Form 10-Q or otherwise made by us or on our behalf. The following information is unaudited and should be read in conjunction with the consolidated financial

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statements and related notes included in this report. We have no obligation to update or revise these forward-looking statements.

### Overview

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We are a communications company providing services to rural areas and small and medium-sized towns and cities as an incumbent local exchange carrier, or ILEC. We offer our ILEC services under the "Frontier" name. In February 2006, we entered into a definitive agreement to sell our competitive local exchange carrier (CLEC), Electric Lightwave, LLC (ELI). We are accounting for ELI as a discontinued operation in our consolidated statements of operations. ELI was sold on July 31, 2006.

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

The communications industry is undergoing significant changes. The market is extremely competitive, resulting in lower prices. These trends are likely to continue and result in a challenging revenue environment. These factors could also result in more bankruptcies in the sector and therefore affect our ability to collect money owed to us by carriers.

Revenues from data and internet services such as high-speed internet continue to increase as a percentage of our total revenues and revenues from high margin services such as local line and access charges and subsidies are decreasing as a percentage of our revenues. These factors, along with the potential for increasing operating costs, could cause our profitability and our cash generated by operations to decrease.

#### (a) Liquidity and Capital Resources

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For the six months ended June 30, 2006, we used cash flow from continuing operations, RTB proceeds and cash and cash equivalents to fund capital expenditures, dividends, interest payments, debt repayments and stock repurchases. As of June 30, 2006, we had cash and cash equivalents aggregating \$141.3 million.

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For the six months ended June 30, 2006, our capital expenditures were \$98.3 million. We continue to closely scrutinize all of our capital projects, emphasize return on investment and focus our capital expenditures on areas and services that have the greatest opportunities with respect to revenue growth and cost reduction. We anticipate capital expenditures of approximately \$270.0 - 280.0 million for 2006.

Increasing competition and improving the capabilities or reducing the maintenance costs of our plant may cause our capital expenditures to increase in the future. Our capital expenditures planned for new services such as wireless and VOIP in 2006 are not material. However, based on the success of our planned roll-out of these products in late 2006, our capital expenditures for these products may increase in the future.



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As of June 30, 2006, we had available lines of credit with financial institutions in the aggregate amount of \$250.0 million. Associated facility fees vary, depending on our debt leverage ratio, and are 0.375% per annum as of June 30, 2006. The expiration date for the facility is October 29, 2009. During the term of the facility we may borrow, repay and reborrow funds. The credit facility is available for general corporate purposes but may not be used to fund dividend payments. We have never borrowed any money under the facility.

Our ongoing annual dividends of \$1.00 per share of common stock under our current policy utilize a significant portion of our cash generated by operations and therefore could limit our operating and financial flexibility. While we believe that the amount of our dividends will allow for adequate amounts of cash flow for other purposes, any reduction in cash generated by operations and any increases in capital expenditures, interest expense or cash taxes would reduce the amount of cash generated in excess of dividends. Losses of access lines, increases in competition, lower subsidy and access revenues and the other factors described above are expected to reduce our cash generated by operations and may require us to increase capital expenditures. The downgrades in our credit ratings to below investment grade may make it more difficult and expensive to refinance our maturing debt. We have in recent years paid relatively low amounts of cash taxes. We expect that over the next several years our cash taxes will increase substantially.

We believe our operating cash flows, existing cash balances, and credit facility will be adequate to finance our working capital requirements, fund capital expenditures, make required debt payments through 2007, pay taxes, pay dividends to our stockholders in accordance with our dividend policy and support our short-term and long-term operating strategies. We have approximately \$29.6 million of debt maturing during the last six months of 2006 and \$37.8 million and \$653.4 million of debt maturing in 2007 and 2008, respectively.

### Share Repurchase Programs

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On May 25, 2005, our Board of Directors authorized us to repurchase up to \$250.0 million of our common stock. This share repurchase program commenced on June 13, 2005. As of December 31, 2005, we completed the repurchase program and had repurchased a total of 18,775,156 shares of our common stock at an aggregate cost of \$250.0 million.

In February 2006, our Board of Directors authorized us to repurchase up to \$300.0 million of our common stock in public or private transactions over the following twelve-month period. This share repurchase program commenced on March 6, 2006. As of June 30, 2006, we had repurchased 10,199,900 shares of our common stock at an aggregate cost of approximately \$135.2 million.

### Debt Reduction and Debt Exchanges

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For the quarter ended June 30, 2006, we retired an aggregate principal amount of \$212.4 million of debt, including \$14.3 million of 5% Company Obligated Mandatorily Redeemable Convertible Preferred Securities due 2006 (EPPICS) that were converted into our common stock. During the first quarter of 2006, we entered into two debt-for-debt exchanges of our debt securities. As a result, \$47.5 million of our 7.625% notes due 2008 were exchanged for approximately \$47.4 million of our 9.00% notes due 2031. The 9.00% notes are callable on the same general terms and conditions as the 7.625% notes exchanged. No cash was exchanged in these transactions, however a non-cash pre-tax loss of approximately \$2.4 million was recognized in accordance with EITF No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments," which is included in other income (loss), net.

On June 1, 2006, we retired at par our entire \$175.0 million principal amount of 7.60% Debentures due June 1, 2006.

On June 14, 2006, we repurchased \$22.7 million of our 6.75% Senior Notes due August 17, 2006 at a price of 100.181% of par.

In February 2006, our Board of Directors authorized us to repurchase up to \$150.0 million of our outstanding debt over the following twelve-month period. These repurchases may require us to pay premiums, which would result in pre-tax losses to be recorded in investment and other income (loss). Through July 31, 2006, we have not made any purchases pursuant to this authorization.

We may from time to time repurchase our debt in the open market, through tender offers, exchanges of debt securities or privately negotiated transactions. We may also exchange existing debt for newly issued debt obligations.

#### Interest Rate Management

In order to manage our interest expense, we have entered into interest swap agreements. Under the terms of these agreements, we make semi-annual, floating rate interest payments based on six month LIBOR and receive a fixed rate on the notional amount. The underlying variable rate on these swaps is set either in advance or in arrears.

The notional amounts of fixed-rate indebtedness hedged as of June 30, 2006 and December 31, 2005 were \$550.0 million and \$500.0 million, respectively. Such contracts require us to pay variable rates of interest (estimated average pay rates of approximately 9.17% as of June 30, 2006 and approximately 8.60% as of December 31, 2005) and receive fixed rates of interest (average receive rate of 8.26% as of June 30, 2006 and 8.46% as of December 31, 2005). All swaps are accounted for under SFAS No. 133 (as amended) as fair value hedges. For the three and six months ended June 30, 2006, the interest expense resulting from these interest rate swaps totaled approximately \$1.1 million and \$1.7 million, respectively.

#### Sale of Non-Strategic Investments

On February 1, 2005, we sold 20,672 shares of Prudential Financial, Inc. for approximately \$1.1 million in cash.

On March 15, 2005, we completed the sale of our conferencing business, CCUSA for approximately \$43.6 million in cash.

In June 2005, we sold for cash our interests in certain key man life insurance policies on the lives of Leonard Tow, our former Chairman and Chief Executive Officer, and his wife, a former director. The cash surrender value of the policies purchased by Dr. Tow totaled approximately \$24.2 million, and we recognized a gain of approximately \$457,000 that is included in investment and other income.

#### Off-Balance Sheet Arrangements

We do not maintain any off-balance sheet arrangements, transactions, obligations or other relationships with unconsolidated entities that would be expected to have a material current or future effect upon our financial statements.

#### EPPICS

In 1996, our consolidated wholly owned subsidiary, Citizens Utilities Trust (the Trust), issued, in an underwritten public offering, 4,025,000 shares of 5%

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Company Obligated Mandatorily Redeemable Convertible Preferred Securities due 2036 (Trust Convertible Preferred Securities or EPPICS), representing preferred undivided interests in the assets of the Trust, with a liquidation preference of \$50 per security (for a total liquidation amount of \$201.3 million). These securities have an adjusted conversion price of \$11.46 per share of our common stock. The conversion price was reduced from \$13.30 to \$11.46 during the third quarter of 2004 as a result of the \$2.00 per share of common stock special, non-recurring dividend. The proceeds from the issuance of the Trust Convertible Preferred Securities and a Company capital contribution were used to purchase \$207.5 million aggregate liquidation amount of 5% Partnership Convertible Preferred Securities due 2036 from another wholly owned consolidated subsidiary, Citizens Utilities Capital L.P. (the Partnership). The proceeds from the issuance of the Partnership Convertible Preferred Securities and a Company capital contribution were used to purchase from us \$211.8 million aggregate principal amount of 5% Convertible Subordinated Debentures due 2036. The sole assets of the Trust are the Partnership Convertible Preferred Securities, and our Convertible Subordinated Debentures are substantially all the assets of the Partnership. Our obligations under the agreements related to the issuances of such securities, taken together, constitute a full and unconditional guarantee by us of the Trust's obligations relating to the Trust Convertible Preferred Securities and the Partnership's obligations relating to the Partnership Convertible Preferred Securities.

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In accordance with the terms of the issuances, we paid the annual 5% interest in quarterly installments on the Convertible Subordinated Debentures in the first and second quarters of 2006 and the four quarters of 2005. Only cash was paid (net of investment returns) to the Partnership in payment of the interest on the Convertible Subordinated Debentures. The cash was then distributed by the Partnership to the Trust and then by the Trust to the holders of the EPPICS.

As of June 30, 2006, EPPICS representing a total principal amount of \$192.2 million have been converted into 15,480,799 shares of our common stock, and a total of \$9.0 million remains outstanding to third parties. Our long-term debt footnote indicates \$19.5 million of EPPICS outstanding at June 30, 2006 of which \$10.5 million is intercompany debt of related parties.

### Covenants

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The terms and conditions contained in our indentures and credit facilities agreements include the timely payment of principal and interest when due, the maintenance of our corporate existence, keeping proper books and records in accordance with GAAP, restrictions on the allowance of liens on our assets, and restrictions on asset sales and transfers, mergers and other changes in corporate control. We currently have no restrictions on the payment of dividends either by contract, rule or regulation.

Our \$200.0 million term loan facility with the Rural Telephone Finance Cooperative (RTFC) contains a maximum leverage ratio covenant. Under the leverage ratio covenant, we are required to maintain a ratio of (i) total indebtedness minus cash and cash equivalents in excess of \$50.0 million to (ii) consolidated adjusted EBITDA (as defined in the agreement) over the last four quarters no greater than 4.00 to 1.

Our \$250.0 million credit facility contains a maximum leverage ratio covenant. Under the leverage ratio covenant, we are required to maintain a ratio of (i) total indebtedness minus cash and cash equivalents in excess of \$50.0 million to (ii) consolidated adjusted EBITDA (as defined in the agreement) over the last four quarters no greater than 4.50 to 1. Although the credit facility is

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unsecured, it will be equally and ratably secured by certain liens and equally and ratably guaranteed by certain of our subsidiaries if we issue debt that is secured or guaranteed.

We are in compliance with all of our debt and credit facility covenants.

### Discontinued Operations

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In February 2006, we entered into a definitive agreement to sell all of the outstanding membership interests in ELI, our CLEC business, to Integra Telecom Holdings, Inc. (Integra), for \$247.0 million, including \$243.0 million in cash plus the assumption of approximately \$4.0 million in capital lease obligations, subject to customary adjustments under the terms of the agreement. This transaction closed on July 31, 2006. We expect to recognize a pre-tax gain on the sale of ELI of approximately \$125.0 million. Our existing tax net operating losses will be used to absorb the potential cash liability for taxes.

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

### Rural Telephone Bank

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In August 2005, the Board of Directors of the Rural Telephone Bank (RTB) voted to dissolve the bank. In November 2005, the liquidation and dissolution of the RTB was initiated with the signing of the 2006 Agricultural Appropriation bill by President Bush. We received approximately \$64.6 million in cash from the dissolution of the RTB in April 2006, which resulted in the recognition of a pre-tax gain of approximately \$61.4 million during the second quarter of 2006. Our existing tax net operating losses will be used to absorb the potential cash liability for taxes.

### Critical Accounting Policies and Estimates

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

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

There have been no material changes to our critical accounting policies and estimates from the information provided in "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our

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Annual Report on Form 10-K for the year ended December 31, 2005.

### New Accounting Pronouncements

#### Accounting for Conditional Asset Retirement Obligations

In March 2005, the FASB issued FIN 47, "Accounting for Conditional Asset Retirement Obligations," an interpretation of FASB No. 143. FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB No. 143 refers to a legal obligation to perform an asset retirement activity in which the timing or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. Although a liability exists for the removal of poles and asbestos, sufficient information is not available currently to estimate our liability, as the range of time over which we may settle these obligations is unknown or cannot be reasonably estimated. The adoption of FIN 47 during the fourth quarter of 2005 had no impact on our financial position, results of operations or cash flows.

#### How Taxes Collected from Customers and Remitted to Governmental Authorities

##### Should be Presented in the Income Statement

In June 2006, the FASB issued EITF Issue No. 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement" (EITF 06-3), which requires disclosure of the accounting policy for any tax assessed by a governmental authority that is directly imposed on a revenue-producing transaction, that is Gross versus Net presentation. EITF 06-3 is effective for periods beginning after December 15, 2006. We do not expect the adoption of EITF 06-3 to have a material impact on our financial position, results of operations or cash flows.

#### Accounting for Uncertainty in Income Taxes

In July 2006, the FASB issued FASB Interpretation No. (FIN) 48, Accounting for Uncertainty in Income Taxes. Among other things, FIN 48 requires applying a "more likely than not" threshold to the recognition and derecognition of tax positions. FIN 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN 48 to have a material impact on our financial position, results of operations or cash flows.

#### Partnerships

In June 2005, the FASB issued EITF No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," which provides new guidance on how general partners in a limited partnership should determine whether they control a limited partnership. EITF No. 04-5 is effective for fiscal periods beginning after December 15, 2005.

The Company applied the provisions of EITF No. 04-5 and consolidated the Mohave Cellular Limited Partnership (Mohave) effective January 1, 2006. As permitted, we elected to apply EITF No. 04-5 retrospectively from the date of adoption. Revenues, depreciation and operating income for Mohave were \$4.8 million, \$0.6 million and \$1.3 million, respectively, for the three months ended June 30, 2006 and \$9.2 million, \$1.1 million and \$2.5 million, respectively, for the six months ended June 30, 2006.

Revenues, depreciation and operating income for Mohave were \$4.0 million, \$0.5 million and \$0.8 million, respectively, for the three months ended June 30, 2005

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and \$7.7 million, \$1.0 million and \$1.5 million, respectively, for the six months ended June 30, 2005.

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### Stock-Based Compensation

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In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R requires that stock-based employee compensation be recorded as a charge to earnings. In April 2005, the Securities and Exchange Commission required adoption of SFAS No. 123R for annual periods beginning after June 15, 2005. Accordingly, we have adopted SFAS 123R commencing January 1, 2006 using a modified prospective application, as permitted by SFAS No. 123R. Accordingly, prior period amounts have not been restated. Under this application, we are required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

Prior to the adoption of SFAS No. 123R, we applied Accounting Principles Board Opinion (APB) No. 25 and related interpretations to account for our stock plans resulting in the use of the intrinsic value to value the stock. Under APB 25, we were not required to recognize compensation expense for the cost of stock options. In accordance with the adoption of SFAS 123R, we recorded stock-based compensation expense for the cost of stock options, restricted shares and stock units issued under our stock plans (together, "Stock-Based Awards"). Stock-based compensation expense for the three months ended June 30, 2006 was \$2.7 million (\$1.7 million after tax or \$0.01 per basic and diluted share of common stock). Stock-based compensation expense for the first six months of 2006 was \$5.3 million (\$3.3 million after tax or \$0.01 per basic and diluted share of common stock).

### (b) Results of Operations

#### REVENUE

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

Consolidated revenue for the three months ended June 30, 2006 increased \$10.8 million, or 2%, as compared with the prior year period.

Consolidated revenue for the six months ended June 30, 2006 increased \$15.3 million, or 2%, as compared with the prior year period.

In February 2006, we entered into a definitive agreement to sell ELI to Integra. As a result, we have classified ELI's results of operations as discontinued operations in our consolidated statements of operations and restated prior periods.

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

Change in the number of our access lines is important to our revenue and profitability. We have lost access lines primarily because of competition, changing consumer behavior, economic conditions, changing technology and by some customers disconnecting second lines when they add high-speed internet or cable

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modem service. We lost approximately 55,900 access lines during the six months ended June 30, 2006 but added approximately 39,000 high-speed internet subscribers during this same period. The loss of lines during the first six months of 2006 was primarily among residential customers. The non-residential line losses were principally in Rochester, New York, while the residential losses were throughout our markets. We expect to continue to lose access lines but to increase high-speed internet subscribers during 2006. A continued loss of access lines, combined with increased competition and the other factors discussed in MD&A, may cause our revenues, profitability and cash flows to decrease in the second half of 2006.

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| (\$ in thousands)          | For the three months ended June 30, |            |            |          | For the      |    |
|----------------------------|-------------------------------------|------------|------------|----------|--------------|----|
|                            | 2006                                | 2005       | \$ Change  | % Change | 2006         |    |
| Local services             | \$ 203,254                          | \$ 205,722 | \$ (2,468) | -1%      | \$ 406,820   | \$ |
| Access services            | 153,582                             | 151,654    | 1,928      | 1%       | 314,550      |    |
| Long distance services     | 38,692                              | 42,337     | (3,645)    | -9%      | 77,850       |    |
| Data and internet services | 54,488                              | 42,392     | 12,096     | 29%      | 104,846      |    |
| Directory services         | 28,547                              | 28,541     | 6          | 0%       | 57,344       |    |
| Other                      | 28,349                              | 25,487     | 2,862      | 11%      | 52,363       |    |
|                            | \$ 506,912                          | \$ 496,133 | \$ 10,779  | 2%       | \$ 1,013,773 | \$ |

Local Services

Local services revenue for the three months ended June 30, 2006 decreased \$2.5 million, or 1% as compared with the prior year period. Local revenue decreased \$4.2 million primarily due to continued losses of access lines. Enhanced services revenue increased \$1.7 million, as compared with the prior year period, primarily due to sales of additional feature packages. Economic conditions or increasing competition could make it more difficult to sell our packages and bundles and cause us to lower our prices for those products and services, which would adversely affect our revenues, profitability and cash flow.

Local services revenue for the six months ended June 30, 2006 decreased \$8.9 million, or 2% as compared with the prior year period. Local revenue decreased \$12.1 million primarily due to continued losses of access lines. Enhanced services revenue increased \$3.2 million, as compared with the prior year period, primarily due to sales of additional feature packages. Economic conditions or increasing competition could make it more difficult to sell our packages and bundles and cause us to lower our prices for those products and services, which would adversely affect our revenues, profitability and cash flow. Rate increases for local access services are expected to increase revenues by approximately \$400,000 monthly beginning August of 2006.

Access Services

Access services revenue for the three months ended June 30, 2006 increased \$1.9 million, or 1%, as compared with the prior year period. Special access revenue increased \$1.4 million primarily due to growth in high-capacity circuits. Access service revenue includes subsidy payments we receive from federal and state agencies. Subsidy revenue increased \$9.0 million primarily due to significantly higher recovery of costs. Switched access revenue decreased \$8.5 million, as compared with the prior year period, primarily due to a decline in minutes of use.

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Access services revenue for the six months ended June 30, 2006 increased \$6.1 million, or 2%, as compared with the prior year period. Special access revenue increased \$5.1 million primarily due to growth in high-capacity circuits. Access service revenue includes subsidy payments we receive from federal and state agencies. Subsidy revenue increased \$11.5 million primarily due to significantly higher recovery of costs. Switched access revenue decreased \$10.6 million, as compared with the prior year period, primarily due to a decline in minutes of use.

Increases in the number of Competitive Eligible Telecommunications Companies (including wireless companies) receiving federal subsidies, among other factors, may lead to further increases in the national average cost per loop (NACPL), thereby resulting in decreases in our subsidy revenue in the future. The FCC and state regulators are currently considering a number of proposals for changing the manner in which eligibility for federal subsidies is determined as well as the amounts of such subsidies. The FCC is also reviewing the mechanism by which subsidies are funded. Additionally, the FCC has an open proceeding to address reform to access charges and other intercarrier compensation. We cannot predict when or how these matters will be decided nor the effect on our subsidy or access revenues. Future reductions in our subsidy and access revenues are not expected to be accompanied by proportional decreases in our costs, so any further reductions in those revenues will directly affect our profitability and cash flows.

### Long Distance Services

Long distance services revenue for the three months ended June 30, 2006 decreased \$3.6 million, or 9%, as compared with the prior period. Long distance services revenue for the six months ended June 30, 2006 decreased \$8.2 million, or 10%, as compared with the prior period. We have actively marketed packages of long distance minutes particularly with our bundled service offerings. The sale of packaged minutes has resulted in an increase in minutes used by our long distance customers and has had the effect of lowering our overall average rate per minute billed. Our long distance minutes of use increased slightly during the second quarter of 2006 compared to the second quarter of 2005. Our long distance revenues may continue to decrease in the future due to lower rates and/or minutes of use. Competing services such as wireless, VOIP, and cable telephony are resulting in a loss of customers, minutes of use and further declines in the rates we charge our customers. We expect these factors will continue to adversely affect our long distance revenues during the remainder of 2006.

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### Data and Internet Services

Data and internet services revenue for the three months ended June 30, 2006 increased \$12.1 million, or 29%, as compared with the prior year primarily due to growth in data and high-speed internet services. Data and internet services revenue for the six months ended June 30, 2006 increased \$23.8 million, or 29%, as compared with the prior year primarily due to growth in data and high-speed internet services. The number of the Company's high-speed internet subscribers has increased by more than 83,000 or 31.1% since June 30, 2005.

### Other

Other revenue for the three months ended June 30, 2006 increased \$2.9 million, or 11%, as compared with the prior year primarily due to a \$1.1 million decrease in bad debt expense due to improved agings, a \$1.2 million increase in customer premise equipment sales and an increase of \$0.8 million in cellular roamer revenue associated with the Mohave Cellular Limited Partnership which is being consolidated in accordance with EITF 04-5 effective January 1, 2006.

Other revenue for the six months ended June 30, 2006 increased \$1.6 million, or



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3%, as compared with the prior year primarily due to an increase of \$1.5 million in cellular roamer revenue.

### COST OF SERVICES

| (\$ in thousands) | For the three months ended June 30, |           |           |          | For the six |         |
|-------------------|-------------------------------------|-----------|-----------|----------|-------------|---------|
|                   | 2006                                | 2005      | \$ Change | % Change | 2006        | 2005    |
| Network access    | \$ 38,402                           | \$ 35,595 | \$ 2,807  | 8%       | \$ 78,620   | \$ 75,3 |

As we continue to increase our sales of data products such as high-speed internet and expand the availability of our unlimited long distance calling plans, our network access expense is likely to increase. Access line losses have offset some of the increase.

### OTHER OPERATING EXPENSES

| (\$ in thousands)             | For the three months ended June 30, |                   |                   |            | For t             |
|-------------------------------|-------------------------------------|-------------------|-------------------|------------|-------------------|
|                               | 2006                                | 2005              | \$ Change         | % Change   | 2006              |
| Operating expenses            | \$ 135,827                          | \$ 141,007        | \$ (5,180)        | -4%        | \$ 274,073        |
| Taxes other than income taxes | 20,934                              | 23,331            | (2,397)           | -10%       | 46,769            |
| Sales and marketing           | 22,739                              | 21,445            | 1,294             | 6%         | 45,959            |
|                               | <u>\$ 179,500</u>                   | <u>\$ 185,783</u> | <u>\$ (6,283)</u> | <u>-3%</u> | <u>\$ 366,801</u> |

Operating expenses for the three months ended June 30, 2006 decreased \$5.2 million, or 4%, as compared with the prior year period primarily due to headcount reductions and associated decreases in salaries and benefits. We have 340 fewer employees as compared to June 30, 2005.

Operating expenses for the six months ended June 30, 2006 decreased \$4.0 million, or 1%, as compared with the prior year period primarily due to headcount reductions and associated decreases in salaries and benefits. We routinely review our operations, personnel and facilities to achieve greater efficiencies. We intend to consolidate our call center operations from 14 locations down to 2 or 3. As we work through the consolidation we expect that our operating expenses will temporarily increase. Our expenses may also increase marginally, as a result of absorbing the common operating costs of ELI and, as noted elsewhere, the introduction of new service offerings may negatively impact our cost structure.

Included in operating expenses is stock compensation expense. Stock compensation expense was \$5.3 million and \$4.4 million for the first six months of 2006 and 2005, respectively and \$2.7 million and \$2.1 million for the three months ended June 30, 2006 and 2005, respectively. In 2006, we began expensing the cost of the unvested portion of outstanding stock options pursuant to SFAS No. 123R. We expect to recognize approximately \$2.2 million of incremental stock compensation expense for the year ended December 31, 2006 assuming no modifications and that actual forfeitures equal estimated forfeitures.

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Included in operating expenses is pension and other postretirement benefit expenses. Based on current assumptions and plan asset values, we estimate that our pension and other postretirement expenses will decrease from \$19.0 million in 2005 to approximately \$15.0 million to \$18.0 million in 2006 and that no contribution will be required to be made by us to the pension plan in 2006. In future periods, if the value of our pension assets decline and/or projected pension and/or postretirement benefit costs increase, we may have increased pension and/or postretirement expenses.

Taxes other than income taxes for the three months ended June 30, 2006 decreased \$2.4 million, or 10% as compared with the prior year period primarily due to refunds received for prior periods.

Taxes other than income taxes for the six months ended June 30, 2006 decreased \$3.0 million, or 6% as compared with the prior year period primarily due to refunds received for prior periods.

Sales and marketing expenses for the three months ended June 30, 2006 increased \$1.3 million, or 6%, as compared with the prior year period primarily due to increased marketing and advertising in an increasingly competitive environment and the launch of new products.

Sales and marketing expenses for the six months ended June 30, 2006 increased \$4.0 million, or 9%, as compared with the prior year period primarily due to increased marketing and advertising in an increasingly competitive environment and the launch of new products. As our markets become more competitive and we launch new products, we expect that our marketing costs will increase. We hope to shift spending from other expense categories to compensate for sales and marketing expense increases.

### DEPRECIATION AND AMORTIZATION EXPENSE

| (\$ in thousands)    | For the three months ended June 30, |            |             |          | For the si |            |
|----------------------|-------------------------------------|------------|-------------|----------|------------|------------|
|                      | 2006                                | 2005       | \$ Change   | % Change | 2006       | 2005       |
| Depreciation expense | \$ 87,957                           | \$ 100,879 | \$ (12,922) | -13%     | \$ 178,366 | \$ 191,288 |
| Amortization expense | 31,595                              | 31,595     | -           | 0%       | 63,190     | 63,190     |
|                      | \$ 119,552                          | \$ 132,474 | \$ (12,922) | -10%     | \$ 241,556 | \$ 254,478 |

Depreciation expense for the three months ended June 30, 2006 decreased \$12.9 million, or 13%, as compared with the prior year period due to a declining asset base and changes in the remaining useful lives of certain assets. Effective with the completion of an independent study of the estimated useful lives of our plant assets, we adopted new lives beginning October 1, 2005. Based on the study and our planned capital expenditures, we expect that our depreciation expense will decline in 2006 to approximately \$350.0 million or by 11% compared to 2005. The decrease is due to a declining asset base and the result of extending the useful lives of our copper facilities. The decrease is expected to be partially offset by the shortening of lives for our switching software assets all in accordance with the independent study.

Depreciation expense for the six months ended June 30, 2006 decreased \$25.0 million, or 12%, as compared with the prior year period due to a declining asset base and changes in the remaining useful lives of certain assets.

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INVESTMENT AND OTHER INCOME (LOSS), NET / INTEREST EXPENSE / INCOME TAX EXPENSE

| (\$ in thousands)        | For the three months ended June 30, |           |           |          | 2006       |
|--------------------------|-------------------------------------|-----------|-----------|----------|------------|
|                          | 2006                                | 2005      | \$ Change | % Change |            |
| Investment and           |                                     |           |           |          |            |
| other income (loss), net | \$ 65,363                           | \$ 573    | \$ 64,790 | 11307%   | \$ 64,012  |
| Interest expense         | \$ 85,341                           | \$ 84,065 | \$ 1,276  | 2%       | \$ 170,734 |
| Income tax expense       | \$ 54,734                           | \$ 17,326 | \$ 37,408 | 216%     | \$ 81,341  |

Investment and other income, net for the three months ended June 30, 2006 increased \$64.8 million as compared with the prior year period primarily due to proceeds received as a result of the liquidation and dissolution of the RTB.

Investment and other income, net for the six months ended June 30, 2006 increased \$59.5 million as compared with the prior year period primarily due to the net proceeds received as a result of the liquidation and dissolution of the RTB partially offset by a \$2.4 million loss we incurred on the exchange of debt during the first quarter of 2006.

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Interest expense for the three months ended June 30, 2006 increased \$1.3 million, or 2%, as compared with the prior year period. The increase in interest expense is due to higher short term interest rates that we pay under our swap agreements (\$550.0 million in principal amount is swapped to floating rate at June 30, 2006). Our composite average borrowing rate (including the effect of our swap agreements) for the three months ended June 30, 2006 as compared with the prior year period was 36 basis points higher, increasing from 7.86% to 8.22%.

Interest expense for the six months ended June 30, 2006 increased \$2.9 million, or 2%, as compared with the prior year period. The increase in interest expense is due to higher short term interest rates that we pay under our swap agreements (\$550.0 million in principal amount is swapped to floating rate at June 30, 2006). Our composite average borrowing rate (including the effect of our swap agreements) for the six months ended June 30, 2006 as compared with the prior year period was 36 basis points higher, increasing from 7.86% to 8.22%.

Income taxes for the three and six months ended June 30, 2006 increased \$37.4 million, or 216%, and \$38.8 million, or 91%, respectively, as compared with the prior year periods primarily due to changes in taxable income. The effective tax rate for the first six months of 2006 was 37.0% as compared with 34.4% for the first six months of 2005. We expect to utilize a substantial amount of tax net operating losses as a result of the sale of ELI and RTB proceeds.

DISCONTINUED OPERATIONS

| (\$ in thousands) | For the three months ended June 30, |      |           |          | For the six |      |
|-------------------|-------------------------------------|------|-----------|----------|-------------|------|
|                   | 2006                                | 2005 | \$ Change | % Change | 2006        | 2005 |

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|                  |           |           |          |      |           |         |
|------------------|-----------|-----------|----------|------|-----------|---------|
| Revenue          | \$ 43,584 | \$ 39,027 | \$ 4,557 | 12%  | \$ 86,078 | \$ 81,6 |
| Operating income | \$ 11,482 | \$ 5,231  | \$ 6,251 | 119% | \$ 21,940 | \$ 8,0  |
| Income taxes     | \$ 4,526  | \$ 2,110  | \$ 2,416 | 115% | \$ 8,488  | \$ 3,0  |
| Net income       | \$ 6,956  | \$ 3,121  | \$ 3,835 | 123% | \$ 13,452 | \$ 5,0  |

In February 2006, we entered into a definitive agreement to sell ELI, our CLEC business, to Integra Telecom Holdings, Inc. (Integra), for \$247.0 million, including \$243.0 million in cash plus the assumption of approximately \$4.0 million in capital lease obligations, subject to customary adjustments under the terms of the agreement. This transaction closed on July 31, 2006. We expect to recognize a pre-tax gain on the sale of ELI of approximately \$125.0 million. Our existing tax net operating losses will be used to absorb the potential cash liability for taxes.

On March 15, 2005, we completed the sale of CCUSA for \$43.6 million in cash, subject to adjustments under the terms of the agreement. The pre-tax gain on the sale of CCUSA was \$14.1 million. Our after-tax gain was \$1.2 million. The book income taxes recorded upon sale are primarily attributable to a low tax basis in the assets sold. Revenue, operating income, income taxes and net income of CCUSA were \$4.6 million, \$1.5 million, \$0.5 million and \$1.0 million, for the six months ended June 30, 2005, respectively.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

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#### Disclosure of primary market risks and how they are managed

We are exposed to market risk in the normal course of our business operations due to ongoing investing and funding activities. Market risk refers to the potential change in fair value of a financial instrument as a result of fluctuations in interest rates and equity prices. We do not hold or issue derivative instruments, derivative commodity instruments or other financial instruments for trading purposes. As a result, we do not undertake any specific actions to cover our exposure to market risks and we are not party to any market risk management agreements other than in the normal course of business or to hedge long-term interest rate risk. Our primary market risk exposures are interest rate risk and equity price risk as follows:

#### Interest Rate Exposure

Our exposure to market risk for changes in interest rates relates primarily to the interest-bearing portion of our investment portfolio and interest on our long-term debt and capital lease obligations. The long term debt and capital lease obligations include various instruments with various maturities and weighted average interest rates.

Our objectives in managing our interest rate risk are to limit the impact of interest rate changes on earnings and cash flows and to lower our overall borrowing costs. To achieve these objectives, a majority of our borrowings have fixed interest rates. Consequently, we have limited material future earnings or cash flow exposures from changes in interest rates on our long-term debt and capital lease obligations. A hypothetical 10% adverse change in interest rates would increase the amount that we pay on our variable obligations and could result in fluctuations in the fair value of our fixed rate obligations. Based upon our overall interest rate exposure at June 30, 2006, a near-term change in interest rates would not materially affect our consolidated financial position, results of operations or cash flows.

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In order to manage our interest rate risk exposure, we have entered into interest rate swap agreements. Under the terms of the agreements, we make semi-annual, floating interest rate interest payments based on six month LIBOR and receive a fixed rate on the notional amount.

### Sensitivity analysis of interest rate exposure

At June 30, 2006, the fair value of our long-term debt was estimated to be approximately \$4.0 billion, based on our overall weighted average interest rate of 8.22% and our overall weighted maturity of 11 years. There has been no material change in the weighted average maturity applicable to our obligations since December 31, 2005.

The overall weighted average interest rate increased approximately 13 basis points during the second quarter of 2006. A hypothetical increase of 82 basis points (10% of our overall weighted average borrowing rate) would result in an approximate \$203.4 million decrease in the fair value of our fixed rate obligations.

### Equity Price Exposure

Our exposure to market risks for changes in equity prices as of June 30, 2006 is limited to our pension assets. We have no other equity investments of any material amount.

### Item 4. Controls and Procedures

#### (a) Evaluation of disclosure controls and procedures

We carried out an evaluation, under the supervision and with the participation of our management, regarding the effectiveness of the design and operation of our disclosure controls and procedures. Based upon this evaluation, our principal executive officer and principal financial officer concluded, as of the end of the period covered by this report, June 30, 2006, that our disclosure controls and procedures are effective.

#### (b) Changes in internal control over financial reporting

We reviewed our internal control over financial reporting at June 30, 2006. There have been no changes in our internal control over financial reporting identified in an evaluation thereof that occurred during the second fiscal quarter of 2006, that materially affected or is reasonably likely to materially affect our internal control over financial reporting.

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## PART II. OTHER INFORMATION CITIZENS COMMUNICATIONS COMPANY SUBSIDIARIES

### Item 1. Legal Proceedings

There have been no material changes to our legal proceedings from the information provided in Item 3. Legal Proceedings included in our Annual Report on Form 10-K for the year ended December 31, 2005, except as set forth below:

As reported in our Annual Report on Form 10-K for the year ended December 31, 2005, the City of Bangor, Maine, filed suit against us on November 22, 2002, in the U.S. District Court for the District of Maine (City of Bangor v. Citizens Communications Company, Civ. Action No. 02-183-B-S). The City alleged, among other things, that we are responsible for the costs of cleaning up environmental contamination alleged to have resulted from the operation of a manufactured gas

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plant owned by Bangor Gas Company from 1852-1948 and by us from 1948-1963. In acquiring the operation in 1948 we acquired the stock of Bangor Gas Company and merged it into us. The City alleged the existence of extensive contamination of the Penobscot River.

On June 27, 2006, the court issued Findings of Fact and Conclusions of Law in the first phase of the case. The court found contamination in only a small section of the River and determined that Citizens and the City should share cleanup costs 60% and 40%, respectively. The precise nature of the remedy in this case remains to be determined by subsequent proceedings. However, based upon the Court's ruling, we believe that we will be responsible for only a portion of the cost to clean up and the final resolution of this matter will not be material to the operating results nor the financial condition of the Company.

Prior to the next phase of the litigation, we intend to (i) seek relief from the Court in connection with the adverse aspects of the Court's opinion and (ii) continue pursuing our right to obtain contribution from the third parties against whom we have commenced litigation in connection with this case. In addition, we have demanded that various of our insurance carriers defend and indemnify us with respect to the City's lawsuit, and on December 26, 2002, we filed a declaratory judgment action against those insurance carriers in the Superior Court of Penobscot County, Maine, for the purpose of establishing their obligations to us with respect to the City's lawsuit. We intend to vigorously pursue this lawsuit and to obtain from our insurance carriers indemnification for any damages that may be assessed against us in the City's lawsuit as well as to recover the costs of our defense of that lawsuit. We cannot at this time determine what amount we may recover from third parties or insurance carriers.

### Item 1A. Risk Factors

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There have been no material changes to our risk factors from the information provided in Item 1A. Risk Factors included in our Annual Report on Form 10-K for the year ended December 31, 2005.

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### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds, Issuer Purchases of Equity Securities

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There were no unregistered sales of equity securities during the quarter ended June 30, 2006.

| Period                          | (a) Total<br>Number of<br>Shares<br>Purchased | (b) Average<br>Price Paid<br>per Share | (c) Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans or<br>Programs | (d) Max<br>Approx<br>Dollar V<br>Shares t<br>Yet<br>Purch<br>Under th<br>or Pro |
|---------------------------------|---|--|--|---|
| -----                           |   |  |  |   |
| April 1, 2006 to April 30, 2006 |   |  |  |   |
| Share Repurchase Program (1)    | 3,016,600                                     | \$ 13.39                               | 3,016,600  | \$ 221,700  |

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|                                       |           |          |           |            |
|---------------------------------------|-----------|----------|-----------|------------|
| Employee Transactions (2)             | -         | \$ -     | N/A       | N/A        |
| May 1, 2006 to May 31, 2006           |           |          |           |            |
| Share Repurchase Program (1)          | 3,512,200 | \$ 13.05 | 3,512,200 | \$ 175,900 |
| Employee Transactions (2)             | 31,571    | \$ 13.00 | N/A       | N/A        |
| June 1, 2006 to June 30, 2006         |           |          |           |            |
| Share Repurchase Program (1)          | 868,200   | \$ 12.81 | 868,200   | \$ 164,800 |
| Employee Transactions (2)             | -         | \$ -     | N/A       | N/A        |
| Totals April 1, 2006 to June 30, 2006 |           |          |           |            |
| Share Repurchase Program (1)          | 7,397,000 | \$ 13.16 | 7,397,000 | \$ 164,800 |
| Employee Transactions (2)             | 31,571    | \$ 13.00 | N/A       | N/A        |

- (1) In February 2006, our Board of Directors authorized us to repurchase up to \$300.0 million of our common stock, in public or private transactions over the following twelve-month period. This share repurchase program commenced on March 6, 2006.
- (2) Includes restricted shares withheld (under the terms of grants under employee stock compensation plans) to offset minimum tax withholding obligations that occur upon the vesting of restricted shares. The Company's stock compensation plans provide that the value of shares withheld shall be the average of the high and low price of the Company's common stock on the date the relevant transaction occurs.

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

- (a) The registrant held its 2006 Annual Meeting of the Stockholders on May 25, 2006 (the "Meeting").
- (b) Election of directors. At the Meeting, all nominees were elected pursuant to the following votes:

| DIRECTORS              | Number of Votes |            |
|------------------------|-----------------|------------|
|                        | FOR             | WITHHELD   |
| Kathleen Q. Abernathy  | 272,733,496     | 4,608,106  |
| Leroy T. Barnes, Jr.   | 267,948,700     | 9,392,902  |
| Jeri Finard            | 266,511,432     | 10,830,170 |
| Lawton Wehle Fitt      | 271,350,832     | 5,990,770  |
| Stanley Harfenist      | 267,347,217     | 9,994,385  |
| William Kraus          | 272,412,971     | 4,928,632  |
| Howard L. Schrott      | 272,966,556     | 4,375,046  |
| Lorraine D. Segil      | 272,944,274     | 4,397,328  |
| Bradley E. Singer      | 272,950,905     | 4,390,698  |
| Edwin Tornberg         | 268,536,513     | 8,805,089  |
| David H. Ward          | 272,875,779     | 4,465,823  |
| Myron A. Wick, III     | 271,037,814     | 6,303,788  |
| Mary Agnes Wilderotter | 267,336,499     | 10,005,103 |

- (c) Other matters submitted to stockholders at the Meeting:

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- (1) Adoption of the Non-Employee Directors' Equity Incentive Plan. The matter passed with the following vote:

|                                  |             |
|----------------------------------|-------------|
| Number of votes FOR              | 163,713,519 |
| Number of votes AGAINST/WITHHELD | 26,163,305  |
| Number of votes ABSTAINING       | 2,085,764   |
| Number of BROKER NON-VOTES       | 85,379,014  |

- (2) Stockholder proposal relating to the Company's future severance agreements with executive officers. The matter passed with the following vote:

|                                  |             |
|----------------------------------|-------------|
| Number of votes FOR              | 128,714,742 |
| Number of votes AGAINST/WITHHELD | 58,240,714  |
| Number of votes ABSTAINING       | 5,041,812   |
| Number of BROKER NON-VOTES       | 85,379,014  |

- (3) Ratification of appointment of KPMG LLP as the Company's independent registered public accounting firm for 2006. The matter passed with the following vote:

|                            |             |
|----------------------------|-------------|
| Number of votes FOR        | 269,499,125 |
| Number of votes AGAINST    | 5,525,370   |
| Number of votes ABSTAINING | 2,317,105   |

### Item 5. Other Information

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As disclosed in our Proxy Statement for the 2006 Annual Meeting, proposals that stockholders wish to include in our proxy statement and form of proxy for our 2007 annual stockholders meeting must be received by the Secretary of the Company no later than December 19, 2006. For a stockholder proposal that is not intended to be included in our proxy statement for our 2007 annual meeting, the proposal must be received by the Secretary of the Company not earlier than January 25, 2007 nor later than February 26, 2007 in order to be properly presented at the 2007 annual meeting. Furthermore, in accordance with the proxy rules and regulations of the Securities and Exchange Commission, if a stockholder does not notify us of a proposal by February 26, 2007, then our proxies would be able to use their discretionary voting authority if a stockholder's proposal is raised at the meeting.

### Item 6. Exhibits

#### a) Exhibits:

- 10.1 Summary of Non-Employee Directors' Compensation.
- 31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
- 31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.



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32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES

SIGNATURE

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Pursuant to the requirements 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.

CITIZENS COMMUNICATIONS COMPANY

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(Registrant)

By: /s/ Robert J. Larson

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Robert J. Larson  
Senior Vice President and  
Chief Accounting Officer

Date: August 3, 2006