U S LIQUIDS INC
Form 10-K/A
July 03, 2003

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A
AMENDMENT NO. 1

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

For the fiscal year ended December 31, 2002

OR

o **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: 001-13259

U S LIQUIDS INC.

(Exact name of Registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**76-0519797** **(I.R.S. Employer Identification No.)**

411 N. Sam Houston Parkway East, Suite 400, Houston, Texas 77060-3545
(Address of principal executive offices)

(281) 272-4500
(Registrant s telephone number including area code)

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

Title of Securities	**Exchange on which Registered**
Common Stock, par value $0.01	American Stock Exchange

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

None

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 x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes o No x

As of June 28, 2002, the last day of the registrant s most recently completed second fiscal quarter, the aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was approximately $44,986,000. For purposes of calculating this amount only, all the directors and executive officers of the registrant as of June 28, 2002 were treated as affiliates.

The number of shares of common stock, $0.01 par value, of the registrant outstanding at March 10, 2003 was 16,233,149.

DOCUMENTS INCORPORATED BY REFERENCE

None

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Consent of Deloitte & Touche LLP
Certification of CEO Pursuant to Section 906
Certification of CFO Pursuant to Section 906

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This document contains forward-looking statements that are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or projected. Key factors that could cause actual results to differ materially from expectations include, but are not limited to: (1) our inability to extend our credit facility or obtain alternative financing; (2) uncertainties caused by our failure to comply with the terms of our credit facility; (3) the impact that our financial condition may have on our customers, suppliers and employees; (4) our general lack of liquidity; (5) the outcome of litigation and administrative proceedings pending against us; (6) obtaining or maintaining of governmental permits and approvals required for the operation of our facilities; (7) changes in the laws and regulations governing our operations; (8) the failure to comply with laws and regulations governing our operations; and (9) the insufficiency of our insurance coverage or the impact of the insolvency of Reliance Insurance Company.

PART I

Item 1. Business

Overview

We are a leading national provider of liquid waste management services, including collection, processing, recovery and disposal services. Assuming the sale of certain operations held for sale or closure, we operate 40 facilities located in 16 states and serve over 10,000 customers in numerous industries. At March 1, 2003, we employed approximately 890 persons full-time. We operate in three divisions the Commercial Wastewater Division, the Industrial Wastewater Division and the Oilfield Waste Division. Our Commercial Wastewater Division collects, processes and disposes nonhazardous liquid waste such as industrial wastewater, bulk liquids and dated beverages. Our Industrial Wastewater Division collects, processes and disposes hazardous and nonhazardous liquid waste such as household hazardous wastes, industrial wastewater, petroleum fuels and antifreeze. The Commercial and Industrial Wastewater Divisions also generate revenue from the sale of by-products recovered from certain waste streams, including oils, ethanol, solvents, plastic, cardboard, aluminum, glass, industrial chemicals and recycled antifreeze products. Our Oilfield Waste Division disposes waste that is generated in the exploration for and production of oil and natural gas, primarily from the Gulf of Mexico and land-based rigs in Louisiana, Texas and northern Mexico.

Our executive offices are located at 411 N. Sam Houston Parkway East, Suite 400, Houston, Texas 77060-3545, and our telephone number is (281) 272-4500. Our common stock is listed on the American Stock Exchange under the trading symbol USL.

Our Internet website is www.usliquids.com. We make available free of charge on or through our Internet website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.

Financing Plans

Our revolving credit facility matures as of April 15, 2003. As of December 31, 2002, we were not in compliance with certain financial covenants of the facility. In addition, a quarterly interest payment of $1.8 million is due under the credit facility on March 31, 2003 and we do not anticipate having the funds available to make this payment. We are presently engaged in discussions with our lenders to defer the payment due on March 31, 2003, extend the maturity date of the facility and make certain other modifications to the credit facility; however, there can be no assurance we will be successful in obtaining any such deferral, extension or modification.

We are also actively engaged in discussions with a number of institutional investors regarding an investment of capital in exchange for newly issued equity or subordinated debt securities. We believe that obtaining this investment will allow us to secure a new credit facility and that the new debt and equity will allow us to repay the existing credit facility. There can be no assurance we will be successful in arranging new financing and if we do, it will result in substantial dilution to our existing stockholders.

Operations and Services Provided

Industrial and commercial businesses produce various types of wastewater (including industrial wastewater, bulk liquids, dated beverages and certain hazardous wastes) that must be disposed of in accordance with federal, state and local regulations. Similarly, oil and gas exploration and production companies produce liquid waste that must be disposed of in accordance with federal and state regulations. We accept liquid waste from generators and independent collection companies, process the liquid waste to remove contaminants and then dispose of the liquid waste in accordance with applicable regulations. In addition, in certain instances, our processing operations generate saleable by-products. Our services permit generators of liquid waste to focus on their primary business activities, while we perform the secondary operations of processing and disposing of their waste.

We collect, process, recover and dispose liquid waste through a number of subsidiaries that are organized into three divisions the Commercial Wastewater Division, the Industrial Wastewater Division and the Oilfield Waste Division. The operations of these three divisions are summarized below. See Note 21 to our consolidated financial statements for certain financial data of these three divisions.

Commercial and Industrial Wastewater Divisions

Overview. The Commercial and Industrial Wastewater Divisions receive fees to collect, process and dispose of hazardous and nonhazardous liquid waste. In addition, the Divisions generate revenue from the sale of by-products recovered from certain waste streams, including oils, ethanol, solvents, plastic, cardboard, aluminum, glass, industrial chemicals and recycled antifreeze products. The Commercial Wastewater Division receives and processes nonhazardous waste such as industrial wastewater, bulk liquids and dated beverages. The Industrial Wastewater Division collects and processes hazardous and nonhazardous liquid waste such as household hazardous wastes, plating solutions, acids, flammable and reactive wastes, industrial wastewater, petroleum fuels and antifreeze. The

Industrial Wastewater Division also processes certain sludges and solid hazardous wastes. The Commercial Wastewater Division contributed approximately 47.2%, 47.1% and 55.1% of our 2002, 2001 and 2000 revenues from continuing operations, respectively. The Industrial Wastewater Division contributed approximately 39.5%, 37.3% and 32.5% of our 2002, 2001 and 2000 revenues from continuing operations, respectively.

Collection. We operate a fleet of vehicles including vacuum trucks, trailers and other transportable containers that collect various types of liquid waste from thousands of generators nationwide. Liquid waste is also received from independent transporters servicing thousands of additional generators, as well as waste shipped directly by the generators via truck, rail or barge.

Processing. Using a variety of physical, chemical, thermal and biological techniques, the liquid waste is broken down into constituent components. Wastewaters suitable for treatment under the Clean Water Act are directed into an appropriate process such as chemical precipitation or filtration. Sludge and solid hazardous wastes are directed to our chemical fixation facility to be pre-treated using chemical oxidation or reduction followed by fixation. Using mechanical and gravity separation techniques, contaminated and off-specification petroleum fuels and used oil are processed to produce a fuel sold primarily to operators of industrial furnaces.

Recovery. Organic wastes that have recoverable heat or solvent values are recycled using distillation techniques. Solvents are sold back to the paint industry as thinners. Other organic wastes are blended into fuels sold primarily to operators of cement or lime kiln facilities. In addition, we have achieved a strong position in the solvent regeneration business, which regenerates nonhazardous solvents.

Disposal. Once waste liquids have been processed, the residual materials must be finally disposed. After thorough testing, solid and semi-solid residues are shipped to an audited and approved independent Subtitle D landfill and treated listed waste residues are sent to an audited and approved independent Subtitle C landfill. Liquid waste residuals include wastewater, which is pretreated and discharged into the publicly operated treatment works (POTW), and solid materials, which are dried and disposed of in an independent solid waste landfill. In some instances, such as printing and cleaning solvents, the contaminants of concern are removed, and the reusable constituents are recovered and returned to the generator for reuse.

Oilfield Waste Division

Overview. Through six processing facilities, we treat and dispose of waste that is generated in the exploration for and production of oil and natural gas. Oilfield waste residuals include saltwater, which is injected into on-site disposal wells; recovered hydrocarbons, which are sold for re-use; and soil, which is generally stockpiled but can be re-used for certain defined applications. In addition, at two Louisiana locations, we clean tanks, barges and other vessels used in the storage and transportation of oilfield waste. The Oilfield Waste Division generated approximately 13.3%, 15.6% and 12.4% of our 2002, 2001 and 2000 revenues from continuing operations, respectively.

Collection, Processing and Disposal. Oilfield wastes are processed using site, soil, climate and biological activities interacting as a system to degrade and/or immobilize constituents, thereby rendering the processed residue suitable for the support of vegetative growth and providing for beneficial land use. The process is designed to reduce oil and grease content, reduce chloride concentrations and immobilize heavy metals.

The treatment process involves several distinct stages. Oilfield waste is brought to the facilities in trucks and on barges, and the delivered waste materials are then tested. Materials that do not qualify as permitted oilfield waste under applicable regulations are rejected. Accepted waste is then loaded into treatment cells, which are flooded with fresh water and mixed to dissolve salts and soluble materials. Saltwater is then pumped out through a collection system and typically disposed of at a saltwater injection well on-site. This flooding process is typically repeated several times. The remaining waste is then processed to remove organic contamination through biological degradation. Total treatment of a cell takes approximately nine to twelve months. In the final stage, the remaining material is tested to ensure compliance with regulatory requirements. Thereafter, the material is transported to on-site stockpile areas.

In November 2002, we acquired six strategically located transfer stations from Trinity Storage Services, L.P. located along the Intracoastal Waterway adjacent to the Gulf of Mexico for approximately $3.0 million in cash and warrants to purchase 100,000 shares of our common stock. These transfer stations provide collection points for the receipt of offshore oilfield waste from all of the major Gulf Coast markets.

Seasonality

The demand for the services provided by our Industrial Wastewater Division is generally cyclical and typically follows general economic trends. We expect that the operations of the Oilfield Waste Division will experience certain seasonal patterns consistent with oil and gas exploration and production activity in the Gulf of Mexico. Generally, the volume of oilfield waste delivered to the Oilfield Waste Division has been lowest in the first quarter of each calendar year. Prices for oil and natural gas are expected to continue to be volatile and affect demand for our oilfield waste services. Certain of the Commercial Wastewater Division s and the Industrial Wastewater Division s processing facilities in the

Northeast and Midwest may be affected by adverse weather conditions.

Competition

The liquid waste industry is highly fragmented and very competitive. Competition in each of the segments of the liquid waste industry in which we operate is primarily on the basis of proximity to collection operations, collection and processing fees charged and quality of service. Our Commercial Wastewater Division competes with numerous smaller, regional providers of liquid waste management services. Our Industrial Wastewater Division competes with Philip Services Corporation, Safety Kleen Corp., Clean Harbors, Inc., Vivendi Environment SA, Waste Management, Inc. and a number of other public and privately-held companies. Our Oilfield Waste Division competes with Newpark Resources, Inc. and a number of smaller companies for oilfield waste produced offshore and on land in the Gulf Coast region.

We believe that there are certain barriers to entry in the markets served by our Industrial Wastewater Division and our Oilfield Waste Division. These barriers include the need for specially equipped facilities and the licenses, permits and trained personnel necessary to operate these facilities.

Regulatory Matters

General

Our business operations are affected both directly and indirectly by governmental regulations, including various federal, state and local pollution control and health and safety programs that are administered and enforced by regulatory agencies. These programs are applicable or potentially applicable to one or more of our existing operations.

Federal Regulation

The primary U.S. federal statutes affecting our business are summarized below:

The Clean Water Act. We treat and discharge wastewaters at our liquid waste facilities and at our oilfield waste landfarms. These activities are subject to the requirements of the Clean Water Act and comparable state statutes and federal and state enforcement of these regulations. The Clean Water Act regulates the discharge of pollutants into waters of the United States. The Clean Water Act establishes a system of standards, permits and enforcement procedures for the discharge of pollutants from industrial and municipal wastewater sources. The law sets treatment standards for industries and wastewater treatment plants and provides federal grants to assist municipalities in complying with the standards. In addition to requiring permits for industrial and municipal discharges directly into the waters of the United States, the Clean Water Act also requires pretreatment of industrial wastewater before discharge into municipal systems.

The Clean Water Act gives the Environmental Protection Agency (EPA) the authority to set pretreatment limits for direct and indirect industrial discharges. In 2001, the EPA adopted new technology-based effluent limitations guidelines for waste treatment facilities that treat or recover hazardous or nonhazardous industrial waste or wastewater received from off-site and then discharge pollutants into United States waters or POTWs. Although the guidelines are based on particular technologies, the new guidelines do not require a facility to use these technologies. Individual facilities may meet the requirements using whatever types of technologies and process changes they choose. Existing indirect discharge facilities such as ours must comply with the new guidelines no later than December 22, 2003. We are currently comparing our existing operations against the new guidelines to determine the modifications necessary to bring our facilities into compliance with the new guidelines. We anticipate that all of our facilities that are subject to these new guidelines will be in compliance therewith by December 2003.

The Clean Water Act also prohibits certain discharges of oil or hazardous substances and authorizes the federal government to remove or arrange for removal of such oil or hazardous substances. In addition, the Clean Water Act requires the adoption of the National Contingency Plan to cover removal of such materials. Under the Clean Water Act, the owner or operator of a vessel or facility may be liable for penalties and costs incurred by the federal government in responding to a discharge of oil or hazardous substances.

The Clean Water Act also has a significant impact on the operations of the Oilfield Waste Division s customers. EPA Region 6, which includes the Oilfield Waste Division s current market, continues to issue new and amended National Pollution Discharge Elimination System general permits further limiting or restricting substantially all discharges of produced water from the Oil and Gas Extraction Point Source Category into waters of the United States. The combined effect of all of these permits closely approaches a zero discharge standard affecting all waters except those of the Outer Continental Shelf. We and many industry participants believe that these permits and the requirements of the Clean Water Act may ultimately lead to a total prohibition of overboard discharge in the Gulf of Mexico.

We believe that each of our operating facilities is currently in substantial compliance with the applicable requirements promulgated pursuant to the Clean Water Act.

RCRA. The Resource Conservation and Recovery Act of 1976 (RCRA) is the principal federal statute governing hazardous and solid waste generation, treatment, storage and disposal. RCRA and state hazardous waste management programs govern the handling and disposal of hazardous waste. The EPA has issued regulations pursuant to RCRA, and states have promulgated regulations under

comparable state statutes, that govern hazardous waste generators, transporters and owners and operators of hazardous waste treatment, storage or disposal facilities. These regulations impose detailed operating, inspection, training and emergency preparedness and response standards and requirements for closure, financial responsibility, manifesting of wastes, record-keeping and reporting, as well as treatment standards for any hazardous wastes intended for land disposal. RCRA-regulated hazardous waste is accepted for processing at our Detroit, Michigan, Tampa, Florida, East Palo Alto, California and Chandler, Arizona facilities and, therefore, each of these facilities is subject to the requirements of Subtitle C of RCRA. Our East Palo Alto and Tampa facilities have each been issued RCRA Part B permits. Our East Palo Alto facility is operating under a California Department of Toxic Substances Control permit that expired in 1991, but that allows for on-going operations. Our Chandler and Detroit facilities have operated under interim status, as allowed by RCRA, since 1994 and 1991, respectively. Applications for final Part B permits for these facilities have been submitted to the appropriate regulatory authorities and we are currently working with the authorities to obtain these final permits. If we are unable to obtain final Part B permits, we may be required to cease operations at these facilities, which in turn could have a material adverse effect on our business, results of operations and financial condition.

The Oilfield Waste Division s facilities treat and dispose of oilfield waste, which is exempt from classification as a RCRA-regulated waste. At various times in the past, proposals have been made to rescind the exemption that excludes oilfield waste from regulation under RCRA. The repeal or modification of this exemption by administrative, legislative or judicial process would require us to change our method of doing business and could have a material adverse effect on our business, results of operations and financial condition. There is no assurance that we would be able to adapt our operations or that we would have the capital resources available to do so.

RCRA also indirectly affects our operations by restricting the disposal of certain liquid wastes and sludges in landfills. This restriction increases demand for the services provided by the Commercial Wastewater and the Industrial Wastewater Divisions.

RCRA regulations also require us to provide financial assurance that funds will be available when needed for closure and post-closure care at our RCRA-regulated facilities, the cost of which could be substantial. Such regulations allow the financial assurance requirements to be satisfied by various means, including letters of credit, surety bonds, trust funds, a financial (net worth) test, and a guarantee by a parent corporation. Under RCRA regulations, a company must pay the closure costs for a facility owned by it upon the closure of the facility and thereafter pay post-closure care costs.

With the exception of the matters described in Item 3. Legal Proceedings, below, we believe that each of our operating facilities is currently in substantial compliance with the applicable requirements promulgated pursuant to RCRA.

CERCLA. The Comprehensive Environmental Response, Compensation and Liability Act, as amended in 1986 (CERCLA), provides for immediate response and removal actions coordinated by the EPA for releases of hazardous substances into the environment and authorizes the government, or private parties, to respond to the release or threatened release of hazardous substances. The government may also order persons responsible for the release to perform any necessary cleanup. Liability extends to the present owners and operators of waste disposal facilities from which a release occurs, persons who owned or operated such facilities at the time the hazardous substances were released, persons who arranged for disposal or treatment of hazardous substances and waste transporters who selected such facilities for treatment or disposal of hazardous substances. CERCLA has been interpreted to create strict, joint and several liability for the cost of removal and remediation, other necessary response costs and damages for injury to natural resources.

If our operations or facilities are responsible for the release or improper disposal of hazardous substances, we could incur CERCLA liability. We may also incur CERCLA liability as a result of environmental contamination caused by hazardous substances, the transportation, treatment or disposal of which we arranged or which was arranged by the owners of a business that we have acquired.

With the exception of the matters described in Item 3. Legal Proceedings, below, we are not aware of any material claims against us or any of our subsidiaries that are based on CERCLA. Nonetheless, the identification of any sites at which cleanup action is required could subject us to liabilities which could have a material adverse effect on our business, results of operations and financial condition.

The Clean Air Act. The Clean Air Act provides for federal, state and local regulation of emissions of air pollutants into the atmosphere. Any modification or construction of a facility with regulated air emissions must be a permitted or authorized activity. The Clean Air Act provides for administrative and judicial enforcement against owners and operators of regulated facilities, including substantial penalties. In 1990, the Clean Air Act was reauthorized and amended, substantially increasing the scope and stringency of the Clean Air Act s regulations. Compliance with the Clean Air Act is not expected to have a material adverse effect on our business, results of operations or financial condition.

State and Local Regulations

Our waste processing facilities are subject to direct regulation by a variety of state and local authorities. Typically, we are required to obtain processing, wastewater discharge and air quality permits from state and local authorities to operate these facilities and to comply

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with applicable regulations concerning, among other things, the generation and discharge of odors and wastewater. In addition, state laws and regulations typically govern the manner in which a waste processing facility may be closed and require us to post financial assurance to assure that all waste will be treated and a facility closed appropriately.

Order 29-B of the Louisiana Department of Natural Resources contains extensive rules regarding the generation, processing, storage, transportation and disposal of oilfield waste. Under Order 29-B, on-site disposal of oilfield waste is limited and subject to stringent guidelines. If these guidelines cannot be met, oilfield waste must be transported and disposed of off-site in accordance with the provisions of Order 29-B. Moreover, under Order 29-B, most, if not all, active waste pits (a typical on-site disposal method used by inland generators of oilfield waste) must be closed or modified to meet regulatory standards; however, full enforcement of this portion of Order 29-B has been deferred. The Texas Railroad Commission has also adopted detailed requirements for the management and disposal of oilfield waste. Permits issued by state regulatory agencies are required for each oilfield waste treatment facility operating within Louisiana and Texas. We must perform tests before acceptance of any oilfield waste, as well as during and after treatment, to ensure compliance with all regulatory requirements.

The states in which we operate have their own laws and regulations that may be more strict than comparable federal laws and regulations governing hazardous and nonhazardous waste disposal, water and air pollution, releases and cleanup of hazardous substances and liabilities for such matters. Our facilities and operations are likely to be subject to many, if not all, of these laws and regulations. In addition, states and localities into which we may expand, by acquisition or otherwise, may now or in the future have regulations with positive or negative effects on us.

Factors Influencing Future Results and Accuracy of Forward-Looking Statements

In the normal course of our business, in an effort to keep our stockholders and the public informed about our operations, we may from time to time issue or make certain statements, either in writing or orally, that are or contain forward-looking statements, as that term is defined in the U.S. federal securities laws. Generally, these statements relate to business plans or strategies, projected or anticipated benefits or other consequences of such plans or strategies, projected or anticipated benefits from acquisitions made by or to be made by us, or projections involving anticipated revenues, earnings or other aspects of operating results. The words may, will, expect, anticipate, believe, estimate, and similar expressions are intended to identify forward-looking statements. We caution readers that such statements are not guarantees of future performance or events and are subject to a number of factors that may tend to influence the accuracy of the statements and the projections upon which the statements are based, including but not limited to those discussed below. As noted elsewhere in this report, all phases of our operations are subject to a number of uncertainties, risks and other influences, many of which are outside of our control, and any one of which, or a combination of which, could materially affect the results of our operations and whether forward-looking statements made by us ultimately prove to be accurate.

The following discussion outlines certain factors that could affect our consolidated results of operations for 2003 and beyond and cause them to differ materially from those that may be set forth in forward-looking statements made by us or on our behalf.

There are substantial risks associated with our current financial condition.

Our revolving credit facility expires on April 15, 2003. As of December 31, 2002, we were not in compliance with certain financial covenants of the credit facility. In addition, a quarterly interest payment of $1.8 million is due under the credit facility on March 31, 2003 and we do not anticipate having the funds available to make this payment. We are presently engaged in discussions with our lenders to defer the payment due on March 31, 2003, extend the maturity date of the credit facility and make certain other modifications to the credit facility; however, there can be no assurance that we will be successful in obtaining any such deferral, extension or modification. Our current financial condition could, if not resolved, have a material adverse impact on our relationships with our customers, suppliers and employees.

Even if the maturity date of the credit facility is extended, there is no assurance that we will be able to continue to satisfy the covenants of the credit facility. A default under the credit facility could result in the maturity of substantially all of our indebtedness being accelerated.

We are also actively engaged in discussions with a number of institutional investors regarding an investment of capital in exchange for newly issued equity or subordinated debt securities. There can be no assurance that we will be successful in arranging new financing and it is likely that any restructuring of our indebtedness will result in substantial dilution to existing stockholders and a change in control of the Company.

Our auditors have stated in their report that the working capital deficit caused by the close proximity of the maturity of our revolving credit facility and the lack of compliance with our credit facility raises substantial doubts about our ability to continue as a going concern. If we are unable to successfully restructure our indebtedness, we may be required to seek protection under the bankruptcy laws.

We have been named as a defendant in a securities class action lawsuit that could have a material adverse effect on our business.

We and certain of our current and former directors and officers have been named as defendants in six securities class action lawsuits, which have been consolidated into a single action styled In Re: U S Liquids Securities Litigation, Case No. H-99-2785 in the United States District Court for the Southern District of Texas. The plaintiffs complaint alleges, among other things, that we violated Sections 11 and 15 of the Securities Act of 1933 by failing to disclose allegedly material information regarding the operation of our Detroit facility and our financial condition in the prospectus relating to our March 1999 stock offering and in certain of our other public filings and announcements. The remedies sought by the plaintiffs include unspecified damages, attorneys and experts fees and costs, rescission to the extent any members of the class still hold common stock and such other relief as the court deems proper. Further proceedings and discovery in the lawsuit have been suspended pending resolution of our dispute with our insurance carrier over whether insurance coverage exists for the claims asserted by the plaintiffs.

If we are not successful in our defense of the class action claim, we could have significant liability to plaintiffs lawyers and our stockholders. In addition, if the court finds that the claims asserted by the plaintiffs are not covered under our insurance policy, we will be forced to make such payments ourselves. Such payments could have a material adverse effect on our business, financial condition, results of operations and prospects, particularly if any required payment is not entirely covered by insurance. Even if our defense against such claims is successful, the litigation could result in substantial costs and divert management s attention and resources, which could adversely affect our business. See Item 3. Legal Proceedings, below, for a more detailed discussion of this class action lawsuit.

We face potential environmental liability.

We possess and dispose of various types of hazardous and nonhazardous wastes at our facilities. There may be various adverse consequences to us in the event that a facility owned or operated by us (including any acquired business) causes or caused environmental damage, in the event that waste transported by us causes or caused environmental damage to another site, in the event that we fail or failed to comply with applicable environmental and land use laws and regulations or the terms of a permit or outstanding consent order, in the event a facility owned or operated by us or the soil or groundwater thereunder is or becomes contaminated or in the event that we are unable to obtain a new permit upon the expiration of an earlier one. These adverse consequences may include the imposition of substantial monetary penalties on us, the issuance of an order requiring the curtailment or termination of the operations involved or affected, the revocation or denial of permits or other approvals necessary for continued operation or expansion of a facility, the imposition of liability on us with respect of any environmental or natural resources damage (including groundwater or soil contamination) at our facilities or that our facilities caused to adjacent landowners or others or environmental damage at another site associated with waste transported by us, the imposition of liability on us under CERCLA, or under comparable state laws, and criminal liability for us or our officers. In addition, citizens groups, adjacent landowners or governmental entities could oppose the issuance of a permit or approval to us or allege violations of the permits pursuant to which we operate or laws or regulations to which we are subject. Any of the foregoing could have a material adverse effect on our business, results of operations, financial condition and prospects. CERCLA and comparable state laws impose retroactive strict joint and several liability on various parties that are, or have been, associated with a site at which there has been, or is threatened, a release of any hazardous substance (as defined by CERCLA) into the environment. Liability under RCRA, CERCLA and comparable state laws may include responsibility for costs of site investigations, site clean up, site monitoring, natural resources damages and property damages. Liabilities under RCRA, CERCLA and comparable state laws can be very substantial and, if imposed upon us, could have a material adverse effect on our business, results of operations, financial condition and prospects.

We may have inadequate insurance.

While we maintain liability insurance, it is subject to coverage limits and certain policies may exclude coverage for damages resulting from environmental contamination. Although there are currently numerous sources from which such coverage may be obtained, it may not continue to be available to us on commercially reasonable terms or the possible types of liabilities that may be incurred by us may not be covered by our insurance. In addition, our insurance carriers may not be able to meet their obligations under the policies or the dollar amount of the liabilities may exceed our policy limits. Even a partially uninsured claim, if successful and of significant magnitude, could have a material adverse effect on our business, results of operations, financial condition and liquidity. We also retain the risk for our uninsured employee group health claims deductibles, which are subject to an annual aggregate stop loss limit on a claim basis and on an aggregate basis.

In October 2001, Reliance Insurance Company (Reliance), one of our primary insurance carriers, was declared insolvent by the Insurance Commissioner of the State of Pennsylvania and placed into liquidation. As a result, insurance coverage is not available for any claims asserted against us for which insurance coverage was to be provided by Reliance and that were not resolved prior to Reliance being placed into liquidation. To the extent that insurance coverage is not available to cover settlement of any such claim asserted against us or a judgment entered against us, we will have to pay the settlement or judgment. There can be no assurance that the $3.7 million reserve existing as of December 31, 2002 will be sufficient to cover amounts expected to be paid in connection with such claims. In addition, there can be no assurance we will have the ability to pay any such claims even though a reserve has been established. Any such claim, if

successful and of significant magnitude, could have a material adverse effect on our business, results of operations, financial condition and liquidity. See Item 3. Legal Proceedings, below.

We may not be able to execute our operating and cost savings strategy.

Key elements of our strategy are to improve the profitability and increase the revenues of our existing operations. We intend to improve the profitability of our existing operations by various means, including achieving operating efficiencies and economies of scale. We have reduced operating costs to improve profitability. We also intend to improve our profitability by selling underperforming businesses, however there can be no assurance that we will be successful in selling any of these businesses or that we will be able to obtain any particular price for any such business. Our ability to increase the revenues and profits of our existing operations will be affected by various factors, including:

- the demand for liquid waste collection, processing and disposal services;
- our ability to expand the range of services offered to customers;
- our ability to develop national and regional accounts for our liquid waste management services and other marketing programs;
- our ability to obtain a final Part B permit for our Detroit and Chandler, Arizona facilities;
- our ability to integrate the Trinity transfer stations with our existing operations; and
- the demand for by-products we recover from certain waste streams.

Many of these factors are beyond our control, and there can be no assurance that our operating and cost savings strategy will be successful or that we will be able to generate cash flows adequate for our operations and to support internal growth. Furthermore, we must implement and improve our operational, financial and management information systems and controls, and train, motivate and manage our employees. We periodically review and upgrade our management information systems, as well as hire additional management and other personnel in order to maintain the adequacy of our operational, financial and management controls. If we are not able to execute our operating and cost savings strategy effectively, our business, results of operations and financial condition could be materially and adversely affected.

Failure to obtain or maintain necessary financial assurance may have a material adverse effect on our business.

Many of our customers require us to post performance bonds to secure our performance under the terms of a contract and to guarantee that we will pay subcontractors and vendors. We are also required to provide financial assurance in order to obtain or renew operating permits and to guarantee that our permitted facilities will be closed in accordance with applicable law. We establish financial assurance for these matters in different ways, depending on the jurisdiction, including letters of credit, surety bonds, trust agreements and traditional insurance. The market for financial assurance is tightening and due to our current financial condition there can be no assurance that we will be able to continue to obtain financial assurance on commercially reasonable terms without providing additional collateral, which collateral may not be available. Continued availability of such financial assurance in sufficient amounts at acceptable rates is a vital aspect of our ongoing operations, and our failure to obtain any such financial assurance would have a material adverse effect on our business, results of operations and financial condition. In January 2003, we made the initial payment on a ten-year finite risk insurance policy. This policy provides up to $18 million toward the projected closure obligations for our facilities, as well as up to $12.4 million of performance bonding capacity. Management believes that this policy will satisfy all of our bonding needs for the foreseeable future but there can be no assurance that this policy will be sufficient to satisfy all of our future bonding needs.

Governmental regulations may have a material adverse effect on our business.

Government regulations have a substantial impact on our business. Each of our products and services is dependent to varying degrees on the existence and enforcement of federal, state and local environmental regulations. Any repeal or relaxation of those regulations, or failure of governmental authorities to enforce the regulations, could result in a decrease in demand for our products and services. We also operate in a highly regulated environment. Our business is subject to numerous federal, state and local laws and regulations governing environmental protection, zoning, transportation, safety, health, land use and other matters. These laws and regulations affect not only the costs of our operations, but also our ability to offer a particular product or service. We are required to have permits and approvals from federal, state and local governments. Any of these permits or approvals or applications could be denied, revoked or modified under various circumstances. The process of obtaining or renewing a required permit or approval can be lengthy and expensive and our efforts to obtain permits, renewals or approvals may be opposed by citizens groups, adjacent landowners or others. In addition, our facilities in Chandler, Arizona and Detroit, Michigan have never been granted Part B permits under RCRA and are continuing to operate under interim status, as allowed by RCRA. Our facility in East Palo Alto, California is operating under a California Department

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of Toxic Substances Control permit that expired in 1991, but that allows for ongoing operations. Although applicable regulations allow these facilities to continue to operate, we may not be successful in obtaining or maintaining these and other required permits and approvals and that failure could have a material adverse effect on our business, results of operations, financial condition and prospects.

Laws and regulations have changed frequently in the past and it is reasonable to expect additional changes in the future. Changes in laws and regulations, or in the interpretations of existing laws and regulations, could have a material adverse effect on our business, results of operations, financial condition and prospects by imposing conditions such as:

- limitations on the construction of new liquid waste disposal, transfer or processing facilities or on the expansion of existing facilities;
- limitations and regulations on collection and disposal prices, rates and volumes;
- limitations or bans on disposal or transportation of out-of-state waste or certain categories of waste;
- mandates regarding the disposal of liquid waste;
- mandates requiring significant capital and operating expenditures to bring our facilities into compliance with new guidelines implemented under the Clean Water Act; and
- mandates requiring us to obtain additional permits or approvals.

In addition, oilfield waste is currently exempt from the requirements of RCRA, which is the principal federal statute governing the handling and disposal of waste. In recent years, proposals have been made to rescind or modify this exemption. The repeal or modification of the exemption covering oilfield waste or modification of applicable regulations or interpretations regarding the processing and disposal of oilfield waste would require us to alter our method of processing and disposing of oilfield waste. This could have a material adverse effect on our business, results of operations and financial condition.

We cannot predict the likely impact any such changes will have on our business. Although we believe that we are presently in material compliance with applicable laws and regulations, our operations may not continue to comply with future laws and regulations. Governmental authorities may seek to impose fines and penalties on us or seek to revoke or deny the issuance or renewal of operating permits for failure to comply with applicable laws and regulations. Under these circumstances, we might be required to curtail or cease operations or conduct site remediation until a particular problem is remedied, any of which could have a material adverse effect on our business, results of operations and financial condition.

The liquid waste management industry is very competitive.

We compete with other liquid waste processing facilities and alternative methods of disposal of certain waste streams provided by area landfills and injection wells, as well as the alternative of illegal disposal. In addition, competitive products and services have been and are likely to continue to be developed and marketed by others. Furthermore, future technological change and innovation may result in a reduction in the amount of liquid waste being generated or alternative methods of processing and disposal being developed. The markets for the various by-products that we sell are also very competitive. With respect to our oilfield waste operations, we must compete with alternative methods of off-site disposal of oilfield waste. We also face competition from customers who develop or enhance their own methods of disposal instead of using the services of liquid waste management companies. Future technological change and innovation may increase the amount of internal oilfield processing and disposal methods and other competitive factors could have a material adverse effect on our business, results of operations and financial condition.

We depend heavily on the oil and gas industry.

Demand for our oilfield waste processing and disposal services depends in large part upon the level of exploration for and production of oil and gas, particularly in the Gulf Coast region. This demand, in turn, depends on, among other things, oil and gas prices, expectations about future prices, the cost of exploring for, producing and delivering oil and gas, the discovery rate of new oil and gas reserves and the ability of oil and gas companies to raise capital. Historically, prices for oil and gas have been extremely volatile and have reacted to changes in the supply of and demand for oil and natural gas, domestic and worldwide economic conditions and political instability in oil-producing countries. Current levels of oil and gas exploration and production activities may not be maintained. Prices for oil and natural gas are expected to continue to be volatile and affect demand for our oilfield waste services. A material decline in oil or natural gas prices or exploration activities could materially affect the demand for our oilfield waste services and, therefore, our business, results of operations and financial condition.

An increase in energy prices may have a material adverse effect on our business.

We operate a fleet of vehicles and other equipment in our operations. In addition, we use significant amounts of energy in the processing of waste. Energy prices are subject to volatility. A significant increase in energy prices could have a material adverse effect on our business, results of operations and financial condition.

The liquid waste management industry is cyclical and seasonal.

The demand for the services provided by our Industrial Wastewater Division is generally cyclical and typically follows general economic trends. We expect that the operations of the Oilfield Waste Division will experience certain seasonal patterns consistent with oil and gas exploration and production activity in the Gulf of Mexico. Generally, the volume of oilfield waste delivered to the Oilfield Waste Division has been lowest in the first quarter of each calendar year. Prices for oil and natural gas are expected to continue to be volatile and affect demand for our oilfield waste services. Certain of the Commercial Wastewater Division s and the Industrial Wastewater Division s processing facilities in the Northeast and Midwest may be affected by adverse weather conditions. The cyclical nature of our Industrial Wastewater Division and future seasonal and quarterly fluctuation could materially and adversely affect our business.

Our failure to maintain satisfactory labor relations could have a material adverse effect on our business.

We currently have approximately 890 full-time equivalent employees. Approximately 60 of these employees are members of various labor unions. In addition, we are currently negotiating a collective bargaining agreement covering approximately 26 employees at our Detroit facility. Our inability to negotiate acceptable contracts with any of these unions as existing agreements expire could result in strikes by the affected workers and increased operating costs as a result of higher wages or benefits paid to union members. If the unionized employees were to engage in a strike or other work stoppage, or other employees were to become unionized, we could experience a significant disruption of our operations and higher on-going labor costs, which could have a material adverse effect on our business, results of operations and financial condition.

We rely on key personnel.

We are highly dependent on our executive officers and senior management. The loss of the services of any of our current executive officers or senior management could have a material adverse effect on our business, results of operations and financial condition.

Item 2. Properties

Our corporate offices are located in Houston, Texas. The corporate offices consist of approximately 20,000 square feet of office space occupied under a lease which expires on June 30, 2007.

Assuming the sale of certain operations held for sale or closure, the Commercial Wastewater Division and Industrial Wastewater Division together operate 28 liquid waste processing and other facilities. We believe that the specialized equipment, licenses and permits necessary to operate the liquid waste processing facilities create a significant barrier to entry into this industry. The following table sets forth certain information relating to each such facility, including the types of liquid waste most commonly managed:

Facility	Location	Liquid Wastes Managed	Facility Type	Owned/Leased
Parallel CA	Rancho Cucamonga, California	Bulk Liquids and Dated Beverages	Processing	Owned
National Solvent	Atlanta, Georgia	Industrial Wastewaters	Processing	Leased
First Source	Rockaway, New Jersey	Industrial Wastewaters	Field Services	Leased
D&H Holding	Hammond, Indiana	Industrial Wastewaters	Processing	Leased
Parallel KY	Louisville, Kentucky	Bulk Liquids and Dated Beverages	Processing	Owned
A&A Environmental	Carlisle, Pennsylvania	Industrial Wastewaters	Field Services	Leased

Baltimore, Maryland	Industrial Wastewaters	Processing	Owned
Salisbury, Maryland	Industrial Wastewaters	Field Services	Leased
Stafford, Virginia	Industrial Wastewaters	Field Services	Leased

Facility	Location	Liquid Wastes Managed	Facility Type	Owned/Leased
Northern A-1	Kalkaska, Michigan	Industrial Wastewaters	Processing	Owned
	Muskegon, Michigan	Industrial Wastewaters	Field Services	Leased
	Montague, Michigan	Industrial Wastewaters	Field Services	Leased
Safety First	Kalkaska, Michigan	N/A	Other	Leased
	Traverse City, Michigan	N/A	Other	Leased
Gateway Terminal	Carteret, New Jersey	Industrial Wastewaters	Processing	Leased
E-Max Allegheny	Pittsburgh, Pennsylvania	Industrial Wastewaters	Processing	Leased
Cactus	Dallas, Texas	Industrial Wastewaters	Collection	Owned
Romic AZ	Chandler, Arizona	Hazardous Wastes; Industrial Wastewaters	Processing	Leased
Romic CA	East Palo Alto, California	Hazardous Wastes; Industrial Wastewaters	Processing	Owned
	Redwood City, California	Hazardous Wastes; Industrial Wastewaters	Processing	Leased
Romic Irwindale	Irwindale, California	Hazardous Wastes; Industrial Wastewaters	Collection	Leased
Romic NW	Clackamas, Oregon	Hazardous Wastes; Industrial Wastewaters	Collection	Leased
Romic Tacoma	Tacoma, Washington	Hazardous Wastes; Industrial Wastewaters	Collection	Leased
USL Florida	Tampa, Florida	Hazardous Wastes; Industrial Wastewaters	Processing	Owned
Waste Research	Augusta, Georgia	Industrial Wastewaters	Processing	Owned
	Macon, Georgia	Industrial Wastewaters	Processing	Owned
	Winston-Salem, North Carolina	Industrial Wastewaters	Field Services	Leased
USL Detroit	Detroit, Michigan	Hazardous Wastes; Industrial Wastewaters	Processing	Owned

The Oilfield Waste Division operates six oilfield waste processing facilities and ten commercial saltwater injection wells. The following table sets forth certain information relating to each processing facility:

Facility	Location	Facility Type	Owned/Leased
USL Louisiana	Bateman Island, Louisiana	Processing	Leased
	Bourg, Louisiana	Processing	Leased
	Elm Grove, Louisiana	Processing	Owned
	Mermentau, Louisiana	Processing	Owned
	Bustamonte, Texas	Processing	Owned
	San Isidro, Texas	Processing	Leased

The Oilfield Waste Division also operates six transfer stations that accept oilfield waste from customers and then transfer the waste to an appropriate processing facility. The following table sets forth certain information relating to each transfer station:

Facility	Location	Facility Type	Owned/Leased
USL Louisiana	Berwick/Morgan City, Louisiana	Transfer Station	Leased
	Cameron, Louisiana	Transfer Station	Leased
	Fourchon, Louisiana	Transfer Station	Leased
	Intracoastal City, Louisiana	Transfer Station	Leased &nbst-Dollar Life Insurance Arrangements --- In September 2006, the FASB reached consensus on the guidance provided by EITF No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. The guidance is applicable to endorsement split-dollar life insurance arrangements, whereby the employer owns and controls the insurance policy, that are associated with a postretirement benefit. EITF No. 06-4 requires that for a split-dollar life insurance arrangement within the scope of the issue, an employer should recognize a liability for future benefits in accordance with FAS No. 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. EITF No. 06-4 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition. Accounting for Purchases of Life Insurance --- In September 2006, the FASB reached consensus on the guidance provided by EITF No. 06-5, Accounting for Purchases of Life Insurance-Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance. EITF No. 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF No. 06-5 also states that a policyholder should determine

the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a 30 group policy). EITF No. 06-5 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition. 31 (b) Results of Operations -------------------- REVENUE Revenue is generated primarily through the provision of local, network access, long distance and data services. Such services are provided under either a monthly recurring fee or based on usage at a tariffed rate and is not dependent upon significant judgments by management, with the exception of a determination of a provision for uncollectible amounts. Consolidated revenue increased $8.3 million, from $2.017 billion in 2005 to $2.025 billion in 2006. Consolidated revenue decreased $5.3 million in 2005. The decrease in 2005 is primarily due to the sale in 2004 of our electric utility property, partially offset by an increase of $4.4 million in telecommunications revenue. Our electric utility contributed $9.7 million of revenue in 2004. In July 2006, we sold our CLEC segment (ELI) to Integra. As a result, we have reclassified ELI's results of operations as discontinued operations in our consolidated statements of operations and restated prior periods. In June 2005, the FASB issued EITF No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights," which provides new guidance on how general partners in a limited partnership should determine whether they control a limited partnership. The Company has applied the provisions of EITF No. 04-5 retrospectively and consolidated Mohave for all periods presented. On March 15, 2005, we completed the sale of our conferencing service business, CCUSA. As a result of the sale, we have classified CCUSA's results of operations as discontinued operations in our consolidated statement of operations and restated prior periods. Change in the number of our access lines is important to our revenue and profitability. We have lost access lines primarily because of competition, changing consumer behavior, economic conditions, changing technology, and by some customers disconnecting second lines when they add high-speed internet or cable modem service. We lost approximately 111,000 access lines during 2006, but added approximately 75,100 high-speed internet subscribers during this same period. We lost 98,800 residential customer lines and 12,200 non-residential customer lines in 2006. The non-residential line losses were principally in Rochester, New York, while the residential losses were throughout our markets. We expect to continue to lose access lines but to increase high-speed internet subscribers during 2007. A continued loss of access lines, combined with increased competition and the other factors discussed in MD&A, may cause our revenues, profitability and cash flows to decrease in 2007. TELECOMMUNICATIONS REVENUE ($ in thousands) 2006 2005 2004 --------------- ---------------------------- ----------------------------- ---------- Amount $ Change % Change Amount $ Change % Change Amount --------- ------------------ ----------- ------------------ ---------- Local services $ 809,584 $ (20,101) -2% $ 829,685 $ (21,392) -3% $ 851,077 Access services 427,959 (3,380) -1% 431,339 (25,589) -6% 456,928 Long distance services 153,272 (16,224) -10% 169,496 (14,127) -8% 183,623 Data and internet services 424,209 58,596 16% 365,613 51,835 17% 313,778 Directory services 114,138 1,046 1% 113,092 2,469 2% 110,623 Other 96,205 (11,611) -11% 107,816 11,202 12% 96,614 ---------- --------- ---------- ---------- ---------- ILEC revenue $2,025,367 $ 8,326 0% $2,017,041 $ 4,398 0% $2,012,643 ========== ========= ========== ========== ========== Local Services Local services revenue for the year ended December 31, 2006 decreased $20.1 million or 2%, as compared with the prior year. Local revenue decreased $25.9 million primarily due to continued losses of access lines partially offset by a local rate increase on some of our Rochester residential access lines effective August 2006. 2005 reflected a reserve of $4.0 million associated with a state rate of return limitation on earnings. Enhanced services revenue increased $5.8 million, primarily due to sales of additional feature packages. Economic conditions and/or increasing competition could make it more difficult to sell our packages and bundles and cause us to lower our prices for those products and services, which would adversely affect our revenues and profitability and cash flow. 32 Local services revenue for the year ended December 31, 2005 decreased $21.4 million or 3%, as compared with the prior year. This decline is comprised of $18.8 million related to the continued loss of access lines and $4.0 million related to a reserve associated with state rate of return limitations on

earnings. Enhanced services revenue increased $5.9 million, as compared with the prior year, primarily due to sales of additional product packages. Access Services Access services revenue for the year ended December 31, 2006 decreased $3.4 million or 1%, as compared with the prior year. Access services includes both switched revenue and subsidy payments. Switched access revenue decreased $13.9 million to $263.4 million. Approximately $24.0 million of the switched access decline was attributable to a decline in minutes of use related to access line losses. This decline was offset by approximately $9.3 million of disputed carrier activity resolved in the Company's favor during the fourth quarter of 2006. Subsidies revenue increased $10.5 million to $164.6 million primarily due to increased receipts from the federal high cost fund due to higher costs in the base year, as well as increased receipts from state high cost funds. Access services revenue for the year ended December 31, 2005 decreased $25.6 million or 6%, as compared with the prior year. Switched access revenue decreased $9.7 million, as compared with the prior year period, primarily due to a decline in minutes of use. Access service revenue includes subsidy payments we receive from federal and state agencies. Subsidy revenue decreased $15.9 million primarily due to decreased Universal Service Fund (USF) support of $19.2 million because of increases in the national average cost per loop (NACPL) and a decrease of $2.0 million related to changes in measured factors, partially offset by an increase of $6.4 million in USF surcharge rates. Increases in the number of Competitive Eligible Telecommunications Companies (including wireless companies) receiving federal subsidies, among other factors, may lead to further increases in the NACPL, thereby resulting in decreases in our subsidy revenue in the future. The FCC and state regulators are currently considering a number of proposals for changing the manner in which eligibility for federal subsidies is determined as well as the amounts of such subsidies. The FCC is also reviewing the mechanism by which subsidies are funded. Additionally, the FCC has an open proceeding to address reform to access charges and other intercarrier compensation. We cannot predict when or how these matters will be decided nor the effect on our subsidy or access revenues. Future reductions in our subsidy and access revenues are not expected to be accompanied by proportional decreases in our costs, so any further reductions in those revenues will directly affect our profitability and cash flows. We currently expect that as a result of an increase in the national average cost per loop, a decrease in our cost structure and the elimination of high speed internet from the calculation of the FCC's USF surcharge (which has a corresponding decrease in operating expenses) there is likely to be a decrease in the total subsidy revenue earned in 2007 and such decrease may be significant in relation to the total amount of our subsidy revenue. Long Distance Services Long distance services revenue for the years ended December 31, 2006 and 2005 decreased $16.2 million or 10% in 2006 and $14.1 million or 8% in 2005, primarily due to a decline in the average rate per minute. Our long distance minutes of use increased during 2006. We have actively marketed bundles or unlimited use of long distance minutes particularly with our packages of multiple services. The sale of bundled and unlimited minutes has resulted in an increase in minutes used by our long distance customers and has had the effect of lowering our overall average rate per minute billed. Our long distance revenues may continue to decrease in the future due to lower rates and/or minutes of use. Competing services such as wireless, VOIP and cable telephony are resulting in a loss of customers, minutes of use and further declines in the rates we charge our customers. We expect these factors will continue to adversely affect our long distance revenues during 2007. Data and Internet Services Data and internet services revenue for the years ended December 31, 2006 and 2005 increased $58.6 million, or 16%, and $51.8 million, or 17%, respectively, as compared with the prior year primarily due to growth in data and high-speed internet services. The number of the Company's high-speed internet subscribers has increased by more than 75,000 or 24% since December 31, 2005. Data & Internet services also includes revenue from data transmission services to other carriers and high-volume commercial customers with dedicated high-capacity circuits like DS-1's and DS-3's. Revenue from these dedicated high-capacity circuits increased $9.1 million in 2006 and $15.0 million in 2005, primarily due to growth in those circuits. 33 Directory Services Directory revenue for the years ended December 31, 2006 and 2005 increased $1.0 million, or 1%, and $2.5 million, or 2%, respectively, as compared with the prior year due to growth in yellow pages advertising. Other Other revenue for the year ended December 31, 2006 decreased $11.6 million or 11%, as compared with the prior year primarily

due to an increase in bad debt expense of $7.5 million and decreases of $2.3 million for promotional credits, $1.8 million in sales of customer premise equipment (CPE) and $1.6 million in "bill and collect" fee revenue. The decreases were partially offset by an increase of $2.5 million for cellular roaming revenue of the Mohave Cellular Limited Partnership. Other revenue for the year ended December 31, 2005 increased $11.2 million, or 12%, compared with the prior year primarily due to a $4.8 million decrease in bad debt expense, a $4.1 million increase in cellular revenue and a $1.8 million increase related to sales of television service. ELECTRIC REVENUE We sold our Vermont electric division on April 1, 2004. Electric revenue for the year ended December 31, 2004 was $9.7 million. We have sold all of our electric operations and as a result will have no operating results in future periods for these businesses. COST OF SERVICES ($ in thousands) 2006 2005 2004 ---------------- ---------------------------- ----------------------------- ---------- Amount $ Change % Change Amount $ Change % Change Amount --------- ------------------ ----------- ------------------ ---------- Network access $ 171,247 $ 14,425 9% $ 156,822 $ 1,431 1% $ 155,391 Electric energy and fuel oil purchased - - - (5,523) -100% 5,523 --------- --------- ----------- ---------- ---------- $ 171,247 $ 14,425 9% $ 156,822 $ (4,092) -3% $ 160,914 ========= ========= =========== ========== ========== Network access Network access expenses for the years ended December 31, 2006 and 2005 increased $14.4 million and $1.4 million, or 9%, and 1%, respectively, as compared with the prior year period. In the fourth quarter of 2006, we expensed $9.7 million of promotional costs associated with a fourth quarter high speed internet promotion that subsidized the cost of a new personal computer for the customer in return for a multi-year contract. The remaining increases in network costs for 2006 and 2005 are primarily due to increasing rates and usage. 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. Electric energy and fuel oil purchased We sold our Vermont electric division on April 1, 2004. Electric energy and fuel oil purchased for the year ended December 31, 2004 was $5.5 million. We have sold all of our electric operations and as a result will have no operating results in future periods for these businesses. OTHER OPERATING EXPENSES ($ in thousands) 2006 2005 2004 ---------------- ---------------------------- ----------------------------- ---------- Amount $ Change % Change Amount $ Change % Change Amount --------- ------------------ ----------- ------------------ ---------- Operating expenses $551,620 $ (21,505) -4% $ 573,125 $ (11,586) -2% $ 584,711 Taxes other than income taxes 86,568 (5,219) -6% 91,787 181 0% 91,606 Sales and marketing 94,955 8,820 10% 86,135 1,302 2% 84,833 --------- --------- ----------- ---------- ---------- $733,143 $ (17,904) -2% $ 751,047 $ (10,103) -1% $ 761,150 ========= ========= =========== ========== ========== Operating Expenses Operating expenses for the year ended December 31, 2006 decreased $21.5 million, or 4%, as compared with the prior year primarily due to headcount reductions and associated decreases in salaries and benefits and improved expense control in benefit costs. 34 Operating expenses for the year ended December 31, 2005 decreased $11.6 million, or 2%, as compared with the prior year primarily due to lower billing expenses as a result of the conversion of one of our billing systems in 2004 partially offset by rate increases for federal USF mandated contributions and annual fees to regulatory agencies. We routinely review our operations, personnel and facilities to achieve greater efficiencies. We are in the process of consolidating our call center operations. As we work through the consolidation, including the opening of a new call center in Deland, FL in August 2006, and the closing of call centers in 2007, we expect that our operating expenses will temporarily increase. As noted elsewhere, the introduction of new service offerings may also negatively impact our cost structure. Included in operating expenses is stock compensation expense. Stock compensation expense was $10.3 million and $8.4 million for the years ended December 31, 2006 and 2005, respectively. In 2006, we began expensing the cost of the unvested portion of outstanding stock options pursuant to SFAS No. 123R. 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 benefit expenses which was $11.3 million in 2006 will be approximately $11.0 million to $14.0 million in 2007 and that no contribution will be required to be made by us to the pension plan in 2007. No contribution was made to

our pension plan during 2006. In future periods, if the value of our pension assets decline and/or projected benefit costs increase, we may have increased pension expenses. Taxes Other than Income Taxes Taxes other than income taxes for the year ended December 31, 2006 decreased $5.2 million, or 6%, as compared with the prior year primarily due to refunds received and changes in revenue subject to gross receipts taxes. Sales and Marketing Sales and marketing expenses for the year ended December 31, 2006 increased $8.8 million, or 10%, as compared with the prior year and increased $1.3 million, or 2% for the year ended 2005 as compared to 2004. Sales and marketing expenses are increasing due to a competitive environment and the launch of new products. As our markets become more competitive and we launch new products, we expect that our marketing costs may increase. DEPRECIATION AND AMORTIZATION EXPENSE ($ in thousands) 2006 2005 2004 ---------------- ----------------------------- ----------------------------- ---------- Amount $ Change % Change Amount $ Change % Change Amount ---------- -------------------------------- ------------------ ---------- Depreciation expense $ 350,107 $ (43,719) -11% $ 393,826 $ (29,035) -7% $ 422,861 Amortization expense 126,380 2 0% 126,378 (142) 0% 126,520 ---------- ---------- ----------- ---------- ---------- $ 476,487 $ (43,717) -8% $ 520,204 $ (29,177) -5% $ 549,381 ========== ========== =========== ========== ========== Depreciation expense for the years ended December 31, 2006 and 2005 decreased $43.7 million, or 11%, and $29.0 million, or 7%, respectively, as compared with the prior years due to a declining net 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. The study concluded that remaining life estimates should be increased for copper facilities and decreased for switching assets (among other less minor changes). This study was updated as of September 30, 2006. Based on the study and our planned capital expenditures, we expect that our depreciation expense will continue to decline in 2007 by approximately 5% as compared to 2006. MANAGEMENT SUCCESSION AND STRATEGIC ALTERNATIVES EXPENSES On July 11, 2004, our Board of Directors announced that it completed its review of our financial and strategic alternatives. In 2004, we expensed $90.6 million of costs related to management succession and our exploration of financial and strategic alternatives. Included are $36.6 million of non-cash expenses for the acceleration of stock benefits, cash expenses of $19.2 million for advisory fees, $19.3 million for severance and retention arrangements and $15.5 million primarily for tax reimbursements. 35 INVESTMENT AND OTHER INCOME (LOSS), NET / INTEREST EXPENSE / INCOME TAX EXPENSE (BENEFIT) ($ in thousands) 2006 2005 2004 ---------------- ------------------------------ ----------------------------- ---------- Amount $ Change % Change Amount $ Change % Change Amount ---------- ------------------ ---------- ----------------- ---------- Investment income $ 83,570 $ 69,230 483% $ 14,340 $ (18,426) -56% $ 32,766 Other income (loss), net $ (1,127) $ 234 17% $ (1,361) $ 52,104 97% $(53,465) Interest expense $336,446 $ (2,289) -1% $338,735 $ (39,556) -10% $378,291 Income tax expense $136,479 $ 61,209 81% $ 75,270 $ 71,023 1672% $ 4,247 Investment Income Investment income for the year ended December 31, 2006 increased $69.2 million as compared with the prior year primarily due to higher cash balances during the year arising from the $65.0 million of cash received from the liquidation and dissolution of the RTB (and gain recognized of $61.4 million), the $255.3 million in cash received from the sale of ELI and the postponement of our stock repurchase and debt repurchase programs during the second half of 2006 in connection with our acquisition of Commonwealth. Investment income for the year ended December 31, 2005 decreased $18.4 million, or 56%, as compared with the prior year primarily due to the sale in 2004 of our investments in D & E Communications, Inc. (D & E) and Hungarian Telephone and Cable Corp. (HTCC), partially offset by higher income in 2005 from short-term investments. Other Income (Loss), net Other income (loss), net for the year ended December 31, 2006 increased $0.2 million as compared to the prior year. Other income (loss) in 2006 consists primarily of the $4.2 million minority share of income in the Mohave Limited Partnership, insurance proceeds of $4.2 million, a loss of $2.4 million on the exchange of debt and gains recognized on the extinguishment of approximately $3.5 million of retained liabilities of our disposed water properties. Other income, net for the year ended December 31, 2005 increased $52.1 million, or 97%, as compared to prior year. The increase is primarily due to a

pre-tax loss from the early extinguishment of debt of $66.5 million in 2004 and a net loss on sales of assets of $1.9 million, which is primarily attributable to the loss on the sale of our corporate aircraft, partially offset by $25.3 million in income from the expiration of certain retained liabilities at less than face value, which are associated with customer advances for construction from our disposed water properties. In addition, during 2005 $7.0 million was reserved in the fourth quarter in connection with a lawsuit, and during the second quarter we incurred a $3.2 million loss on the exchange of debt, partially offset by gains on our forward rate agreements. Interest Expense Interest expense for the year ended December 31, 2006 decreased $2.3 million, or 1%, as compared with the prior year primarily due to lower average debt levels partially offset by higher short term interest rates that we pay on our swap agreements ($550.0 million in principal amount is swapped to floating rate at December 31, 2006). Our composite average borrowing rate for the year ended December 31, 2006 as compared with the prior year was 18 basis points higher, increasing from 7.94% to 8.12%. With the expected acquisition of Commonwealth and the related incurrence of indebtness we expect our interest expense to increase in 2007. In December we borrowed $400.0 million in advance of the acquisition and another $150.0 million to be used for debt retirements. We expect the need to borrow another $200.0 - $300.0 million to close the Commonwealth transaction, pay all closing transaction costs and implementation costs. Interest expense for the year ended December 31, 2005 decreased $39.6 million, or 10%, as compared with the prior year primarily due to the retirement and refinancing of debt. Our composite average borrowing rate for the year ended December 31, 2005 as compared with the prior year was 2 basis points lower, decreasing from 7.96% to 7.94%. Income Taxes Income taxes for the year ended December 31, 2006 increased $61.2 million, or 81%, as compared with the prior year primarily due to changes in taxable income. The effective tax rate for 2006 was 35% as compared with an effective tax rate of 29% for 2005. We expect to utilize a substantial amount of tax net operating losses as a result of the sale of ELI and receipt of the RTB proceeds. We expect that in 2007 our cash paid for income taxes will increase significantly. 36 Income taxes for the year ended December 31, 2005 increased $71.0 million, as compared with the prior year primarily due to changes in taxable income and the effective tax rate. The effective tax rate for 2005 was 28.6% as compared with 6.9% for 2004. Our effective tax rate was below statutory rates in both years as a result of the completion of audits with federal and state taxing authorities and changes in the structure of certain of our subsidiaries. DISCONTINUED OPERATIONS ($ in thousands) 2006 2005 2004 ---------------- --------- --------- ---------- Amount Amount Amount --------- --------- ---------- Revenue $ 100,612 $ 163,768 $180,588 Operating income $ 27,882 $ 22,969 $ 24,809 Income taxes $ 11,583 $ 9,519 $ 9,132 Net income $ 18,912 $ 13,266 $ 15,086 Gain on disposal of ELI and CCUSA, net of tax $ 71,635 $ 1,167 $ - On July 31, 2006, we sold our CLEC business, Electric Lightwave LLC (ELI) for $255.3 million (including the sale of associated real estate) in cash plus the assumption of approximately $4.0 million in capital lease obligations. We recognized a pre-tax gain on the sale of ELI of approximately $116.7 million. Our after-tax gain on the sale was $71.6 million. Our cash liability for taxes as a result of the sale is expected to be approximately $5.0 million due to the utilization of existing tax net operating losses on both the federal and state level. On March 15, 2005, we completed the sale of CCUSA for $43.6 million in cash. The pre-tax gain on the sale of CCUSA was $14.1 million. Our after-tax gain was $1.2 million. The book income taxes recorded upon sale are primarily attributable to a low tax basis in the assets sold. Item 7A. Quantitative and Qualitative Disclosures about Market Risk -- 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, including those associated with our pension assets. Market risk refers to the potential change in fair value of a financial instrument as a result of fluctuations in interest rates and equity and commodity 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. 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. The long-term debt includes 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, all but $150.0 million 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. 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 December 31, 2006, a near-term change in interest rates would not materially affect our consolidated financial position, results of operations or cash flows. In order to manage our interest expense, we have entered into interest rate swap agreements. Under the terms of the agreements, which qualify for hedge accounting, 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 for these interest rate swaps is set in arrears. For the years ended December 31, 2006 and 2005, the net cash interest payment or (savings) resulting from these interest rate swaps totaled approximately $4.2 million and $(2.5) million, respectively. 37 Sensitivity analysis of interest rate exposure At December 31, 2006, the fair value of our long-term debt was estimated to be approximately $4.6 billion, based on our overall weighted average borrowing rate of 8.19% and our overall weighted maturity of 13 years. There has been no material change in the weighted average maturity since December 31, 2005. The overall weighted average interest rate on our long-term debt increased in 2006 by approximately 11 basis points. A hypothetical increase of 82 basis points in our weighted average interest rate (10% of our overall weighted average borrowing rate) would result in an approximate $238.0 million decrease in the fair value of our fixed rate obligations or an increase in our annual interest expense of approximately $5.75 million. Equity Price Exposure Our exposure to market risks for changes in equity prices as of December 31, 2006 is limited to our pension assets of $770.2 million. We have no other equity investments of any material amount. Item 8. Financial Statements and Supplementary Data --- The following documents are filed as part of this Report: 1. Financial Statements, See Index on page F-1. 2. Supplementary Data, Quarterly Financial Data is included in the Financial Statements (see 1. above). Item 9. Changes in and Disagreements with Accountants on Accounting and --- Financial Disclosure -------------------- None. Item 9A. Controls and Procedures ---------------------- (i) Disclosure Controls and Procedures We carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, 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, December 31, 2006, that our disclosure controls and procedures are effective. (ii) Internal Control Over Financial Reporting (a) Management's annual report on internal control over financial reporting Our management report on internal control over financial reporting appears on page F-4. (b) Attestation report of registered public accounting firm The attestation report of KPMG LLP, our independent registered public accounting firm, on management's assessment of the effectiveness of our internal control over financial reporting appears on page F-3. (c) Changes in internal control over financial reporting. We reviewed our internal control over financial reporting at December 31, 2006. There has been no change in our internal control over financial reporting during the last fiscal quarter of 2006 that materially affected or is reasonably likely to materially affect our internal control over financial reporting. Item 9B. Other Information ---------------- None. PART III -------- Item 10. Directors and Executive Officers of the Registrant --- 38 The information required by this Item is incorporated by reference from our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the SEC pursuant to Regulation 14A within 120 days after December 31, 2006. See "Executive Officers of the Registrant" in Part I of this Report following Item 4 for information relating to executive officers. Item 11. Executive Compensation --------------------- The information required by this Item is incorporated by reference from our definitive

proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the SEC pursuant to Regulation 14A within 120 days after December 31, 2006. Item 12. Security Ownership of Certain Beneficial Owners and Management and --- Related Stockholder Matters -------------------------- The information required by this Item is incorporated by reference from our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the SEC pursuant to Regulation 14A within 120 days after December 31, 2006. Item 13. Certain Relationships and Related Transactions --- The information required by this Item is incorporated by reference from our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the SEC pursuant to Regulation 14A within 120 days after December 31, 2006. Item 14. Principal Accountant Fees and Services ------------------------------------ The information required by this Item is incorporated by reference from our definitive proxy statement for the 2007 Annual Meeting of Stockholders to be filed with the SEC pursuant to Regulation 14A within 120 days after December 31, 2006. PART IV ------- Item 15. Exhibits and Financial Statement Schedules --- List of Documents Filed as a Part of This Report: (1) Index to Consolidated Financial Statements: Report of Independent Registered Public Accounting Firm Consolidated balance sheets as of December 31, 2006 and 2005 Consolidated statements of operations for the years ended December 31, 2006, 2005 and 2004 Consolidated statements of shareholders' equity for the years ended December 31, 2006, 2005 and 2004 Consolidated statements of comprehensive income (loss) for the years ended December 31, 2006, 2005 and 2004 Consolidated statements of cash flows for the years ended December 31, 2006, 2005 and 2004 Notes to consolidated financial statements All other schedules have been omitted because the required information is included in the consolidated financial statements or the notes thereto, or is not applicable or required. 39 (2) Index to Exhibits: Exhibit No. Description ------- ----------- 3.1 Restated Certificate of Incorporation of Citizens Communications Company, (filed as Exhibit 3.200.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2000).* 3.2 By-laws of Citizens Communications Company, as amended (filed as Exhibit 99.2 to the Company's Current Report on Form 8-K filed on May 31, 2006).* 4.1 Rights Agreement, dated as of March 6, 2002, between Citizens Communications Company and Mellon Investor Services, LLC, as Rights Agent (filed as Exhibit 1 to the Company's Registration Statement on Form 8-A filed on March 22, 2002).* 4.2 Certificate of Trust of Citizens Communications Trust dated as of April 27, 2001 (filed as Exhibit 4.5 to Amendment No.1 to the Company's Form S-3 filed on May 7, 2001 (Registration No. 333-58044)). * 4.3 Trust Agreement of Citizens Capital Trust I, dated as of April 27, 2001 (filed as Exhibit 4.6 to Amendment No.1 to the Company's Form S-3 filed on May 7, 2001 (Registration No. 333-58044)). * 4.4 Form of Senior Note due 2011 (filed as Exhibit 4.4 to the Company's Current Report on Form 8-K filed on May 24, 2001 (the "May 24, 2001 8-K")). * 4.5 Form of Senior Note due 2008 and due 2031 (filed as Exhibit 4.1 to the Company's Current Report on Form 8-K filed on August 22, 2001). * 4.6 Form of Senior Note due 2013 (filed as Exhibit 4.2 to the Company's Current Report on Form 8-K filed on November 12, 2004 (the "November 12, 2004 8-K")). * 4.7 5% Convertible Subordinated Debenture due 2036 (filed as Exhibit A to Exhibit 4.200.2 to the Company's Form 8-K Current Report filed on May 28, 1996 (the "May 28, 1996 8-K")). * 4.8 Amended and Restated Declaration of Trust dated as of January 15, 1996, of Citizens Utilities Trust (filed as Exhibit 4.200.4 to the May 28, 1996 8-K). * 4.9 Convertible Preferred Security Certificate (filed as Exhibit A-1 to Exhibit 4.200.4 to the May 28, 1996 8-K). * 4.10 Amended and Restated Limited Partnership Agreement dated as of January 15, 1996 of Citizens Utilities Capital L.P. (filed as Exhibit 4.200.6 to the May 28, 1996 8-K). * 4.11 Partnership Preferred Security Certificate (filed as Annex A to Exhibit 4.200.6 to the May 28, 1996 8-K).* 4.12 Convertible Preferred Securities Guarantee Agreement dated as of January 15, 1996 between Citizens Communications Company (f/k/a Citizens Utilities Company) and JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as guarantee trustee (filed as Exhibit 4.200.8 to the May 28, 1996 8-K). * 4.13 Partnership Preferred Securities Guarantee Agreement dated as of January 15, 1996 between Citizens Communications Company (f/k/a Citizens Utilities Company) and JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as guarantee trustee (filed as Exhibit 4.200.9 to the May 28, 1996 8-K). * 4.14 Letter of

Representations dated January 18, 1996, from Citizens Communications Company (f/k/a Citizens Utilities Company) and JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as trustee, to DTC, for deposit of Convertible Preferred Securities with DTC (filed as Exhibit 4.200.10 to the May 28, 1996 8-K). * 4.15 Indenture of Securities, dated as of August 15, 1991, and JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as Trustee (filed as Exhibit 4.100.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 1991). * 4.16 Indenture, dated as of January 15, 1996, between Citizens Communications Company (f/k/a Citizens Utilities Company) and JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as indenture trustee (filed as Exhibit 4.200.1 to the May 28, 1996 8-K). * 4.17 First Supplemental Indenture, dated as of January 15, 1996, between Citizens Communications Company (f/k/a Citizens Utilities Company) and JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as indenture trustee (filed as Exhibit 4.200.2 to the May 28, 1996 8-K). * 4.18 Fourth Supplemental Indenture, dated October 1, 1994, to JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as Trustee (filed as Exhibit 4.100.7 to the Company Current Report on Form 8-K filed on January 3, 1995). * 4.19 Fifth Supplemental Indenture, dated as of June 15, 1995, to JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as Trustee (filed as Exhibit 4.100.8 to the Company Current Report on Form 8-K filed on March 29, 1996 (the "March 29, 1996 8-K")).* * Incorporated by reference. 40 4.20 Sixth Supplemental Indenture, dated as of October 15, 1995, to JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), as Trustee (filed as Exhibit 4.100.9 to the March 29, 1996 8-K). * 4.21 Seventh Supplemental Indenture, dated as of June 1, 1996 to JPMorgan Chase Bank, N.A. (as successor to Chemical Bank),(filed as Exhibit 4.100.11 to the Company's Annual Report on Form 10-K for the year ended December 31, 1996 (the "1996 10-K")). * 4.22 Eighth Supplemental Indenture, dated as of December 1, 1996 to JPMorgan Chase Bank, N.A. (as successor to Chemical Bank), (filed as Exhibit 4.100.12 to the 1996 10-K). * 4.23 Senior Indenture, dated as of May 23, 2001, between Citizens Communications Company and JPMorgan Chase Bank, N.A.(as successor to The Chase Manhattan Bank), as trustee (filed as Exhibit 4.1 to the May 24, 2001 8-K). * 4.24 First Supplemental Indenture, dated as of May 23, 2001, to Senior Indenture, (filed as Exhibit 4.2 of the May 24, 2001 8-K). * 4.25 Third Supplemental Indenture, dated as of November 12, 2004, to Senior Indenture, dated as of May 23, 2001 (filed as Exhibit 4.1 to the November 12, 2004 8-K). * 4.26 Indenture, dated as of August 16, 2001, between Citizens Communications Company and JPMorgan Chase Bank, N.A.(as successor to The Chase Manhattan Bank), as Trustee (filed as Exhibit 4.1 of the Company's Current Report on Form 8-K filed on August 22, 2001). * 4.27 Indenture, dated as of December 22, 2006, between Citizens Communications Company and The Bank of New York, as Trustee (filed as Exhibit 4.1 to the Company's Current Report on Form 8-K filed on December 29, 2006 (the "December 29, 2006 8-K")). * 4.28 Registration Rights Agreement, dated December 22, 2006, between Citizens Communications Company and Citigroup Global Markets Inc., Credit Suisse Securities (USA) LLC and J.P. Morgan Securities Inc. (filed as Exhibit 4.2 to the December 29, 2006 8-K). * 10.1 Competitive Advance and Revolving Credit Facility Agreement for $250,000,000 dated October 29, 2004(filed as Exhibit 10.19 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2004 (the "3rd Quarter 2004 10-Q")).* 10.2 Credit Agreement, dated as of December 6, 2006, among Citizens Communications Company, as the Borrower, and CoBank, ACB, as the Administrative Agent, the Lead Arranger and a Lender, and the other Lenders referred to therein (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on December 6, 2006). * 10.3 Amended and Restated Non-Employee Directors' Deferred Fee Equity Plan dated as of May 18, 2004 (filed as Exhibit 10.1.2 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2004 (the "2nd Quarter 2004 10-Q")). * 10.4 Amendment No. 1 to the Amended and Restated Non-Employee Directors' Deferred Fee Equity Plan (filed as Exhibit 10.2 to the Company's Current Report on Form 8-K filed on December 20, 2005). * 10.5 Non-Employee Directors' Equity Incentive Plan (filed as Appendix B to the Company's Proxy Statement dated April 17, 2006). * 10.6 Separation Agreement between Citizens Communications Company and Leonard Tow effective July 10, 2004 (filed as Exhibit 10.2.4 of the 2nd Quarter 2004 10-Q). * 10.7 Citizens Executive Deferred Savings Plan dated January 1, 1996 (filed as Exhibit 10.19 to the Company's Annual Report on Form 10-K for the year

ended December 31, 1999 (the "1999 10-K")). * 10.8 Citizens Incentive Plan restated as of March 21, 2000 (filed as Exhibit 10.19 to the 1999 10-K). * 10.9 1996 Equity Incentive Plan (filed as Appendix A to the Company's Proxy Statement dated March 29, 1996). * 10.10 2000 Equity Incentive Plan, as amended (filed as Appendix A to the Company's Proxy Statement dated April 20, 2005). * 10.11 Amendment to 1996 Equity Incentive Plan (filed as Exhibit B to the Company's Proxy Statement dated March 28, 1997). * 10.12 Amendment to 1996 Equity Incentive Plan (effective March 4, 2005) (filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2005). * 10.13 Citizens 401(K) Savings Plan effective as of January 1, 1997, as amended (filed as Exhibit 10.37 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2001).* 10.14 Loan Agreement between Citizens Communications Company and Rural Telephone Finance Cooperative for $200,000,000 dated October 24, 2001 (filed as Exhibit 10.39 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2001). * 10.15 Amendment No. 1, dated as of March 31, 2003, to Loan Agreement between Citizens Communications Company and Rural Telephone Finance Cooperative (filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2003). * 41 10.16 Employment Agreement between Citizens Communications Company and Mary Agnes Wilderotter, effective November 1, 2004 (filed as Exhibit 10.16 to the 3rd Quarter 2004 10-Q). * 10.17 Employment Agreement between Citizens Communications Company and Robert Larson, effective September 1, 2004 (filed as Exhibit 10.18 to the 3rd Quarter 2004 10-Q). * 10.18 Employment Agreement between Citizens Communications Company and John H. Casey, III, effective February 15, 2005 (filed as Exhibit 10.20 to the Company's Annual Report on Form 10-K for the year ended December 31, 2004 (the "2004 10-K")). * 10.19 Offer of Employment Letter between Citizens Communications Company and Peter B. Hayes, effective February 1, 2005 (filed as Exhibit 10.23 to the 2004 10-K). * 10.20 Offer of Employment Letter between Citizens Communications Company and Donald R. Shassian, effective March 8, 2006 (filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2006). * 10.21 Separation Agreement between Citizens Communications Company and L. Russell Mitten dated July 13, 2005 (filed as Exhibit 10.24 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2005 (the "3rd Quarter 2005 10-Q")).* 10.22 Amendment to the Separation Agreement between Citizens Communications Company and L. Russell Mitten dated August 31, 2005 (filed as Exhibit 10.24.1 to the 3rd Quarter 2005 10-Q). * 10.23 Summary of Compensation Arrangements for Named Executive Officers Outside of Employment Agreements (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed February 26, 2007). * 10.24 Summary of Non-Employee Directors' Compensation Arrangements Outside of Formal Plans, (filed as Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2006). * 10.25 Membership Interest Purchase Agreement between Citizens Communications Company and Integra Telecom Holdings, Inc. dated February 6, 2006 (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on February 9, 2006). * 10.26 Stock Redemption Agreement between Citizens Utilities Rural Company, Inc. and The Rural Telephone Bank effective November 10, 2005 (including schedule of substantially identical agreements with other Subsidiaries of the Registrant) (filed as Exhibit 10.24 to the Company's Annual Report on Form 10-K for the year ended December 31, 2005). * 10.27 Agreement and Plan of Merger dated as of September 17, 2006 among Commonwealth Telephone Enterprises, Inc., Citizens Communications Company and CF Merger Corp. (filed as Exhibit 2.1 to the Company's Current Report on Form 8-K filed on September 18, 2006). * 12.1 Computation of ratio of earnings to fixed charges (this item is included herein for the sole purpose of incorporation by reference). 21.1 Subsidiaries of the Registrant 23.1 Auditors' Consent 31.1 Certification of Principal Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 (the "1934 Act"). 31.2 Certification of Principal Financial Officer pursuant to Rule 13a-14(a) under the 1934 Act. 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 ("SOXA"). 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of SOXA . Exhibits 10.3, 10.4, 10.5, 10.6, 10.7, 10.8, 10.9, 10.10, 10.11, 10.12,

10.15, 10.16, 10.17, 10.18, 10.19, 10.20, 10.21, 10.22 and 10.23 are management contracts or compensatory plans or arrangements. 42 SIGNATURES ---------- Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized. CITIZENS COMMUNICATIONS COMPANY ------------------------------- (Registrant) By: /s/ Mary Agnes Wilderotter -------------------------- Mary Agnes Wilderotter Chairman of the Board, President and Chief Executive Officer February 28, 2007 43 Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 28th day of February 2007. Signature Title --------- ----- /s/ Kathleen Q. Abernathy Director --- (Kathleen Q. Abernathy) /s/ Leroy T. Barnes, Jr. Director --- (Leroy T. Barnes, Jr.) /s/ Michael T. Dugan Director --- (Michael T. Dugan) /s/ Jeri B. Finard Director --- (Jeri B. Finard) /s/ Lawton Fitt Director --- (Lawton Fitt) /s/ Stanley Harfenist Director --- (Stanley Harfenist) /s/ William Kraus Director --- (William Kraus) /s/ Robert J. Larson Senior Vice President and --- Chief Accounting Officer (Robert J. Larson) /s/ Howard L. Schrott Director --- (Howard L. Schrott) /s/ Larraine D. Segil Director --- (Larraine D. Segil) /s/ Donald R. Shassian Chief Financial Officer --- (Donald R. Shassian) /s/ Bradley E. Singer Director --- (Bradley E. Singer) /s/ Edwin Tornberg Director --- (Edwin Tornberg) /s/ David H. Ward Director --- (David H. Ward) /s/ Myron A. Wick III Director --- (Myron A. Wick III) /s/ Mary Agnes Wilderotter Chairman of the Board, --- President and Chief Executive (Mary Agnes Wilderotter) Officer 44 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES Index to Consolidated Financial Statements Item Page ---- ----- Reports of Independent Registered Public Accounting Firm F-2 and F-3 Management's Report on Internal Control Over Financial Reporting F-4 Consolidated balance sheets as of December 31, 2006 and 2005 F-5 Consolidated statements of operations for the years ended December 31, 2006, 2005 and 2004 F-6 Consolidated statements of shareholders' equity for the years ended December 31, 2006, 2005 and 2004 F-7 Consolidated statements of comprehensive income (loss) for the years ended December 31, 2006, 2005 and 2004 F-7 Consolidated statements of cash flows for the years ended December 31, 2006, 2005 and 2004 F-8 Notes to consolidated financial statements F-9 F-1 Report of Independent Registered Public Accounting Firm --- The Board of Directors and Shareholders Citizens Communications Company: We have audited the accompanying consolidated balance sheets of Citizens Communications Company and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity, comprehensive income and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion. In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Citizens Communications Company and subsidiaries as of December 31, 2006 and 2005 and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. As discussed in Notes 1 and 2 to the

accompanying consolidated financial statements, effective January 1, 2006, the Company adopted the fair value method of accounting for stock-based compensation as required by Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" and Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." Also, as discussed in Note 2 to the accompanying consolidated financial statements, the Company adopted the recognition and disclosure provisions of Statement of Financial Accounting Standards No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" as of December 31, 2006. We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Citizens Communications Company and subsidiaries internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 28, 2007 expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting. /s/ KPMG LLP Stamford, Connecticut February 28, 2007 F-2 Report of Independent Registered Public Accounting Firm -- The Board of Directors and Shareholders Citizens Communications Company: We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Citizens Communications Company and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Citizens Communications Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. In our opinion, management's assessment that Citizens Communications Company and subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Citizens Communications Company and subsidiaries maintained, in all material respects,

effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Citizens Communications Company and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of operations, shareholders' equity and comprehensive income and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated February 28, 2007 expressed an unqualified opinion on those consolidated financial statements. /s/ KPMG LLP Stamford, Connecticut February 28, 2007 F-3 Management's Report on Internal Control Over Financial Reporting --- The Board of Directors and Shareholders Citizens Communications Company: The management of Citizens Communications Company and subsidiaries is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Under the supervision and with the participation of our management, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control--Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation our management concluded that our internal control over financial reporting was effective as of December 31, 2006 and for the period then ended. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2006 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report which is included herein. Stamford, Connecticut February 28, 2007 F-4 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2006 AND 2005 ($ in thousands) 2006 2005 -------------- -------------- ASSETS ------ Current assets: Cash and cash equivalents $ 1,041,106 $ 263,749 Accounts receivable, less allowances of $108,537 and $31,385, respectively 187,737 203,070 Prepaid expenses 30,377 27,753 Other current assets 13,773 12,447 Assets of discontinued operations - 162,716 -------------- -------------- Total current assets 1,272,993 669,735 Property, plant and equipment, net 2,983,504 3,058,312 Goodwill, net 1,917,751 1,921,465 Other intangibles, net 432,353 558,733 Investments 16,474 15,999 Other assets 168,130 203,323 -------------- -------------- Total assets $ 6,791,205 $ 6,427,567 ============== ============== LIABILITIES AND SHAREHOLDERS' EQUITY ------------------------------------ Current liabilities: Long-term debt due within one year $ 39,271 $ 227,693 Accounts payable 153,890 140,494 Advanced billings 39,417 29,245 Income taxes accrued 9,897 5,776 Other taxes accrued 21,434 20,501 Interest accrued 103,342 101,021 Other current liabilities 58,392 70,763 Liabilities of discontinued operations - 46,266 -------------- -------------- Total current liabilities 425,643 641,759 Deferred income taxes 514,130 325,084 Other liabilities 332,645 423,785 Long-term debt 4,460,755 3,995,130 Shareholders' equity: Common stock, $0.25 par value (600,000,000 authorized shares; 322,265,000 and 328,168,000 outstanding, respectively, and 343,956,000 issued at December 31, 2006 and 2005) 85,989 85,989 Additional paid-in capital 1,207,399 1,374,610 Retained earnings/(deficit) 134,705 (85,344) Accumulated other comprehensive loss, net of tax (81,899) (123,242) Treasury stock (288,162) (210,204) -------------- -------------- Total shareholders' equity 1,058,032 1,041,809 -------------- -------------- Total liabilities and shareholders' equity $ 6,791,205 $ 6,427,567 ============== ============== The accompanying Notes are an integral part of these Consolidated Financial Statements. F-5 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 and 2004 ($ in thousands, except for per-share amounts) 2006 2005 2004 --------------- -------------- -------------- Revenue $ 2,025,367 $ 2,017,041 $ 2,022,378 Operating expenses: Cost of services (exclusive of depreciation and amortization) 171,247 156,822 160,914 Other operating expenses 733,143 751,047 761,150 Depreciation and amortization 476,487 520,204 549,381 Management succession and strategic alternatives expenses - - 90,632 --------------- -------------- -------------- Total operating expenses 1,380,877 1,428,073 1,562,077 --------------- -------------- -------------- Operating income 644,490 588,968 460,301

Investment income 83,570 14,340 32,766 Other income (loss), net (1,127) (1,361) (53,465) Interest expense 336,446 338,735 378,291 --------------- -------------- ------------- Income from continuing operations before income taxes 390,487 263,212 61,311 Income tax expense 136,479 75,270 4,247 --------------- -------------- ------------- Income from continuing operations 254,008 187,942 57,064 Discontinued operations (see Note 8): Income from discontinued operations 147,136 36,844 24,218 Income tax expense 56,589 22,411 9,132 --------------- -------------- -------------- Income from discontinued operations 90,547 14,433 15,086 --------------- -------------- ------------- Net income available for common shareholders $ 344,555 $ 202,375 $ 72,150 =============== ============== ============== Basic income per common share: Income from continuing operations $ 0.79 $ 0.56 $ 0.19 Income from discontinued operations 0.28 0.04 0.05 --------------- -------------- -------------- Net income per common share $ 1.07 $ 0.60 $ 0.24 =============== ============== ============== Diluted income per common share: Income from continuing operations $ 0.78 $ 0.56 $ 0.18 Income from discontinued operations 0.28 0.04 0.05 --------------- -------------- -------------- Net income per common share $ 1.06 $ 0.60 $ 0.23 =============== ============== ============== The accompanying Notes are an integral part of these Consolidated Financial Statements. F-6 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 and 2004 (dollars and shares in thousands, except for per-share amounts) Accumulated Common Stock Additional Other Treasury Stock Total ------------------ Paid-In Retained Comprehensive ----------------- Shareholders' Shares Amount Capital Earnings (Defict) Income (Loss) Shares Amount Equity --------- -------- ----------- ------------------ ------------ ------ ---------- ------------ --------- -------- ----------- ------------------ ------------ ------ ---------- ------------ Balance December 31, 2003 295,434 $ 73,858 $1,953,317 $ (365,181) $ (71,676) (10,725) $(175,135) $ 1,415,183 Stock plans 4,821 1,206 14,236 - - 6,407 106,823 122,265 Conversion of EPPICS 10,897 2,724 133,621 - - 725 11,646 147,991 Conversion of Equity Units 28,483 7,121 396,221 - - 3,591 56,658 460,000 Dividends on common stock of $2.50 per share - - (832,768) - - - - (832,768) Net income - - - 72,150 - - - 72,150 Tax benefit on equity forward contracts - - - 5,312 - - - 5,312 Other comprehensive loss, net of tax and reclassifications adjustments - - - - (27,893) - - (27,893) --------- -------- ------------ -------------- ------------- -------- ---------- ------------ Balance December 31, 2004 339,635 84,909 1,664,627 (287,719) (99,569) (2) (8) 1,362,240 Stock plans 2,096 524 24,039 - - 2,598 34,689 59,252 Conversion of EPPICS 2,225 556 24,308 - - 391 5,115 29,979 Dividends on common stock of $1.00 per share - - (338,364) - - - - (338,364) Shares repurchased - - - - - (18,775) (250,000) (250,000) Net income - - - 202,375 - - - 202,375 Other comprehensive loss, net of tax and reclassifications adjustments - - - - (23,673) - - (23,673) --------- -------- ------------ -------------- ------------- -------- ---------- ------------- Balance December 31, 2005 343,956 85,989 1,374,610 (85,344) (123,242) (15,788) (210,204) 1,041,809 Cumulative Effect Adjustment (see Note 5) - - - 36,392 - - - 36,392 Stock plans - - (1,875) - - 2,908 38,793 36,918 Conversion of EPPICS - - (2,563) - - 1,389 18,488 15,925 Dividends on common stock of $1.00 per share - - (162,773) (160,898) - - - (323,671) Shares repurchased - - - - - (10,200) (135,239) (135,239) Net income - - - 344,555 - - - 344,555 Pension Liability Adjustment, after adoption of SFAS 158, net of taxes - - - - (83,634) - - (83,634) Other comprehensive income, net of tax and reclassifications adjustments - - - - 124,977 - - 124,977 --------- -------- ------------ -------------- ------------- -------- ---------- ------------- Balance December 31, 2006 343,956 $ 85,989 $1,207,399 $ 134,705 $ (81,899) (21,691) $(288,162) $ 1,058,032 ========= ======== ============ ============== ============== ======== ========== ============= CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 and 2004 ($ in thousands, except for per-share amounts) 2006 2005 2004 -------------- -------------- ------------- Net income $ 344,555 $ 202,375 $ 72,150 Other comprehensive income (loss), net of tax and reclassifications adjustments* 124,977 (23,673) (27,893) -------------- -------------- ------------- Total comprehensive income $ 469,532 $ 178,702 $ 44,257 ============== ============== ============= * Consists of unrealized holding (losses)/gains of marketable securities, realized gains taken to income as a result of the sale of securities and minimum pension and other post-retirement liabilities (see Note 21). The

accompanying Notes are an integral part of these Consolidated Financial Statements. F-7 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 and 2004 ($ in thousands) 2006 2005 2004 --------------- -------------- ---------------- Cash flows provided by (used in) operating activities: Net income $ 344,555 $ 202,375 $ 72,150 Deduct: Gain on sale of discontinued operations - (net) (71,635) (1,167) - Income from discontinued operations - (net) (18,912) (13,266) (15,086) Adjustments to reconcile income to net cash provided by operating activities: Depreciation and amortization expense 476,487 520,204 549,381 Gain on expiration/settlement of customer advance (3,539) (681) (25,345) Stock based compensation expense 10,340 8,427 47,581 Loss on debt exchange 2,420 3,175 - Loss on extinguishment of debt - - 66,480 Investment gains (61,428) (492) (12,066) Gain on sales of assets - - 1,945 Other non-cash adjustments 8,743 23,119 31,262 Deferred taxes 132,031 100,636 24,016 Change in accounts receivable 15,333 8,782 6,804 Change in accounts payable and other liabilities (3,064) (37,257) (62,234) Change in other current assets (2,148) 5,313 (3,639) --------------- --------------- ---------------- Net cash provided by operating activities 829,183 819,168 681,249 Cash flows provided from (used by) investing activities: Proceeds from sales of assets, net of selling expenses - 24,195 30,959 Proceeds from sale of discontinued operations 255,305 43,565 - Capital expenditures (268,806) (259,448) (263,949) Securities sold - 1,112 26,514 Other asset (purchased) distributions received 67,050 (139) (28,234) --------------- -------------- ---------------- Net cash provided from (used by) investing activities 53,549 (190,715) (234,710) Cash flows provided from (used by) financing activities: Repayment of customer advances for construction and contributions in aid of construction (264) (1,662) (2,089) Long-term debt borrowings 550,000 - 700,000 Debt issuance costs (6,948) - (15,502) Long-term debt payments (227,693) (6,299) (1,202,403) Premium to retire debt - - (66,480) Issuance of common stock 27,200 47,550 544,562 Shares repurchased (135,239) (250,000) - Dividends paid (323,671) (338,364) (832,768) --------------- -------------- ---------------- Net cash used by financing activities (116,615) (548,775) (874,680) Cash flows of discontinued operations: Operating cash flows 17,833 27,500 32,294 Investing cash flows (6,593) (11,388) (14,820) Financing cash flows - (134) (11,618) --------------- --------------- ---------------- 11,240 15,978 5,856 Increase (decrease) in cash and cash equivalents 777,357 95,656 (422,285) Cash and cash equivalents at January 1, 263,749 168,093 590,378 --------------- -------------- ---------------- Cash and cash equivalents at December 31, $ 1,041,106 $ 263,749 $ 168,093 =============== ============== ================ Cash paid during the period for: Interest $ 332,204 $ 318,638 $ 370,128 Income taxes (refunds) $ 5,365 $ 4,711 $ (4,901) Non-cash investing and financing activities: Change in fair value of interest rate swaps $ (1,562) $ (13,193) $ (6,135) Conversion of EPPICS $ 15,925 $ 29,980 $ 147,991 Debt-for-debt exchange $ 2,433 $ 2,171 $ - Investment write-downs $ - $ - $ 5,286 The accompanying Notes are an integral part of these Consolidated Financial Statements. F-8 CITIZENS COMMUNICATIONS COMPANY AND SUBSIDIARIES Notes to Consolidated Financial Statements (1) Description of Business and Summary of Significant Accounting Policies: -- (a) Description of Business: ----------------------- Citizens Communications Company and its subsidiaries are referred to as "we," "us," the "Company," or "our" in this report. 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. (b) Principles of Consolidation and Use of Estimates: -- Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). 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. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions which affect the amounts of assets, liabilities, revenue and expenses we have reported and our disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from those estimates. We believe that our critical estimates are depreciation rates, pension assumptions, calculations of impairment amounts,

reserves established for receivables, income taxes and contingencies. (c) Cash Equivalents: ---------------- We consider all highly liquid investments with an original maturity of three months or less to be cash equivalents. (d) 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. (e) 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. (f) 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 and have determined for the year ended December 31, 2006 that there was no impairment. Statement of Financial Accounting Standards (SFAS) No. 142 also requires that intangible assets 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 to determine whether any changes to those lives are required. F-9 (g) 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. (h) 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," as amended. 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. On the date we enter into a derivative contract that qualifies for hedge accounting, we designate the derivative as either a fair value or cash flow hedge. A hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment is a fair value hedge. A hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability is a cash flow hedge. We formally document all relationships between hedging instruments and hedged items, as well as our risk-management objective and strategy for undertaking the hedge transaction. This process includes linking all derivatives that are designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. We also formally assess, both at the hedge's

inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. If it is determined that a derivative is not highly effective as a hedge or that it has ceased to be a highly effective hedge, we would discontinue hedge accounting prospectively. All derivatives are recognized on the balance sheet at their fair value. Changes in the fair value of derivative financial instruments are either recognized in income or shareholders' equity (as a component of other comprehensive income), depending on whether the derivative is being used to hedge changes in fair value or cash flows. 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 swaps is carried on the balance sheet in other liabilities and the related hedged liabilities are also adjusted to fair value by the same amount. (i) Investments: ------------ Marketable Securities We classify our cost method investments at purchase as available-for-sale. We do not maintain a trading portfolio or held-to-maturity securities. Our marketable securities are insignificant (see Note 9). Investments in Other Entities Investments in entities that we do not control, but where we have the ability to exercise significant influence over operating and financial policies, are accounted for using the equity method of accounting (see Note 9). (j) Income Taxes and Deferred Income Taxes: -------------------------------------- We file a consolidated federal income tax return. We utilize the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recorded for the tax effect of temporary differences between the financial statement basis and the tax basis of assets and liabilities using tax rates expected to be in effect when the temporary differences are expected to reverse. F-10 (k) 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 had 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 SFAS No. 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 SFAS No. 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 year ended December 31, 2006 was $10.3 million ($6.7 million after tax, or $0.02 per basic and diluted share of common stock). 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 No. 25, we were not required to recognize compensation expense for the cost of stock options issued under the Management Equity Incentive Plan (MEIP), 1996 Equity Incentive Plan (EIP) and the Amended and Restated 2000 EIP stock plans. Prior to 2006, we provided pro forma net income and pro forma net

income per common share disclosures for employee and non-employee director stock option grants based on the fair value of the options at the date of grant (see Note 17). For purposes of presenting pro forma information, the fair value of options granted is computed using the Black Scholes option-pricing model. F-11 Had we determined compensation cost based on the fair value at the grant date for the Management Equity Incentive Plan (MEIP), Equity Incentive Plan (EIP), Employee Stock Purchase Plan (ESPP) and Non-Employee Directors' Deferred Fee Equity Plan, our pro forma net income and net income per common share available for common shareholders would have been as follows: 2006 2005 2004 ---------------- ---------------- ---------------- ($ in thousands) (No Change) ---------------- Net income available for common shareholders As reported $202,375 $ 72,150 Add: Stock-based employee compensation expense included in reported net income, net of related tax effects 5,267 29,381 Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects (8,165) (38,312) -------- -------- Pro forma $199,477 $ 63,219 ======== ======== Net income per common share As reported: available for common shareholders Basic $ 0.60 $ 0.24 Diluted 0.60 0.23 Pro forma: Basic $ 0.59 $ 0.21 Diluted 0.59 0.20 In connection with the payment of the special, non-recurring dividend of $2.00 per common share on September 2, 2004, the exercise price and number of all outstanding options was adjusted such that each option had the same value to the holder after the dividend as it had before the dividend. In accordance with FASB Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions Involving Stock Compensation" and EITF No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB No. 25 and FIN No. 44," there is no accounting consequence for changes made to the exercise price and the number of shares of a fixed stock option or award as a direct result of the special, non-recurring dividend. (l) Net Income Per Common Share Available for Common Shareholders: --- Basic net income per common share is computed using the weighted average number of common shares outstanding during the period being reported on. Except when the effect would be antidilutive, diluted net income per common share 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 common shares 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 to common stock. (2) Recent Accounting Literature and Changes in Accounting Principles: --- Accounting for Defined Benefit Pension and Other Postretirement Plans --- In October 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (OPEB), which completes the first phase of a FASB project that will comprehensively reconsider accounting for pensions and other postretirement benefit plans and amends the following FASB Statements: F-12 * SFAS No. 87, "Employers' Accounting for Pensions;" * SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits;" * SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions;" and * SFAS No. 132(R), "Employers' Disclosures about Pensions and Other Postretirement Benefits." SFAS No. 158 requires (1) recognition of the funded status of a benefit plan in the balance sheet, (2) recognition in other comprehensive income of gains or losses and prior service costs or credits arising during the period but which are not included as components of periodic benefit cost, (3) measurement of defined benefit plan assets and obligations as of the balance sheet date, and (4) disclosure of additional information about the effects on periodic benefit cost for the following fiscal year arising from delayed recognition in the current period. For public companies, the requirements to recognize the funded status of a plan and to comply with the disclosure provisions of SFAS No. 158 are effective as of the end of the fiscal year that ends after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the balance sheet date is effective for fiscal years ending after December 15, 2008. See Note 24. Consideration of Prior Years' Errors in Quantifying Current Year --- Misstatements ------------ In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, "Consideration of Prior Years' Errors in Quantifying Current Year Misstatements."

SAB No. 108 provides guidance concerning the process to be applied in considering the impact of prior years' errors in quantifying misstatements in the current year. SAB No. 108 is effective for periods ending after November 15, 2006. The Company adopted SAB No. 108 in the fourth quarter of 2006. See Note 5. 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 No. 48 requires applying a "more likely than not" threshold to the recognition and derecognition of uncertain tax positions. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of FIN No. 48 to have a material 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 No. 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 No. 06-3 is effective for periods beginning after December 15, 2006. We will adopt the disclosure requirements of EITF No. 06-3 commencing January 1, 2007. Exchanges of Productive Assets ----------------------------- In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets," an amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of certain non-monetary assets (except for certain exchanges of products or property held for sale in the ordinary course of business). The Statement requires that non-monetary exchanges be accounted for at the fair value of the assets exchanged, with gains or losses being recognized, if the fair value is determinable within reasonable limits and the transaction has commercial substance. SFAS No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. We have not had any "exchanges of nonmonetary" assets. F-13 Accounting for Conditional Asset Retirement Obligations -- In March 2005, the FASB issued FIN No. 47, "Accounting for Conditional Asset Retirement Obligations," an interpretation of FASB No. 143. FIN No. 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 No. 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 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 No. 47 during the fourth quarter of 2005 had no impact on our financial position or results of operations. Accounting Changes and Error Corrections -------------------------------------- In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20 and FASB Statement No. 3. SFAS No. 154 changes the accounting for, and reporting of, a change in accounting principle. SFAS No. 154 requires retrospective application to prior period's financial statements of voluntary changes in accounting principle, and changes required by new accounting standards when the standard does not include specific transition provisions, unless it is impracticable to do so. The adoption of SFAS No. 154 during the first quarter of 2006 had no impact on our financial position or results of operations. 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. We are the managing partner and have a 33% ownership position in a wireless voice business, Mohave Cellular Limited Partnership (Mohave). The Company has applied the provisions of EITF No. 04-5 retrospectively and consolidated Mohave for all periods presented. Selected data for the Mohave partnership is as follows: ($ in thousands)

Year Ended December 31, -------------- ---------------------- 2006 2005 2004 ------ ------ ------ Revenues $18,458 $16,151 $12,084 Depreciation Expense $ 2,022 $ 2,053 $ 1,864 Operating Income $ 6,035 $ 3,599 $ 817 Accounting for Endorsement Split-Dollar Life Insurance Arrangements -- In September 2006, the FASB reached consensus on the guidance provided by EITF No. 06-4, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. The guidance is applicable to endorsement split-dollar life insurance arrangements, whereby the employer owns and controls the insurance policy, that are associated with a postretirement benefit. EITF No. 06-4 requires that for a split-dollar life insurance arrangement within the scope of the issue, an employer should recognize a liability for future benefits in accordance with FAS No. 106 (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. EITF No. 06-4 is effective for fiscal years beginning after December 15, 2007. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition. F-14 Accounting for Purchases of Life Insurance -- In September 2006, the FASB reached consensus on the guidance provided by EITF No. 06-5, Accounting for Purchases of Life Insurance--Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance. EITF No. 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF No. 06-5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). EITF No. 06-5 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact the adoption of the standard will have on the Company's results of operations or financial condition. (3) Proposed Acquisition of Commonwealth Telephone: -- On September 17, 2006, we entered into a definitive agreement to acquire Commonwealth Telephone for $41.72 per share, in a cash-and-stock taxable transaction, for a total purchase price of $1.2 billion. Each Commonwealth share will receive $31.31 in cash and 0.768 shares of Citizens' common stock. We expect to issue approximately 21 million shares in the merger. The acquisition has been approved by the Boards of Directors of both Citizens and Commonwealth and by Commonwealth's shareholders. The acquisition has received the requisite Hart-Scott Rodino and FCC approvals, but is still subject to Pennsylvania PUC approval. We expect the transaction to be consummated in the first half of 2007. We intend to finance the cash portion of the transaction with a combination of cash on hand and debt. We obtained a commitment letter for a $990.0 million senior unsecured term loan, the proceeds of which may be used to pay the cash portion of the acquisition consideration (including cash payable upon the assumed conversion of $300.0 million of the Commonwealth convertible notes in connection with the acquisition), to cash out restricted shares, options and other equity awards of Commonwealth, to repay all of Commonwealth's outstanding indebtedness (which was $35.0 million as of December 31, 2006) and to pay fees and expenses related to the acquisition. We expect to refinance this term loan, which matures within one year, with long-term debt prior to the maturity thereof. On December 22, 2006, this commitment was reduced by $400.0 million as the result of our issuance of 7.875% senior notes due 2027 in the amount of $400.0 million. In December 2006, we borrowed $150.0 million from CoBank under a 6 year unsecured term loan. These proceeds can be used to repurchase existing indebtedness or to essentially reduce the amount of additional borrowings needed in connection with the Commonwealth transaction. We expect the need to borrow $200.0 million - $300.0 million under the remaining commitment to close the Commonwealth transaction, pay all closing transaction costs and implementation costs. F-15 (4) Property, Plant and Equipment: ----------------------------- The components of property, plant and equipment at December 31, 2006 and 2005 are as follows: Estimated ($ in thousands) Useful Lives 2006 2005 ---------------- ------------------ ----------------- ------------------ Land N/A $

17,944 $ 17,921 Buildings and leasehold improvements 41 years 324,230 320,789 General support 5 to 17 years 425,952 411,191 Central office/electronic circuit equipment 5 to 11 years 2,602,168 2,509,769 Cable and wire 15 to 60 years 3,171,421 3,052,560 Other 20 to 30 years 11,800 22,307 Construction work in progress 131,951 98,582 ---------------- ----------------- 6,685,466 6,433,119 Less: accumulated depreciation (3,701,962) (3,374,807) ---------------- ----------------- Property, plant and equipment, net $ 2,983,504 $ 3,058,312 ================ ================= Depreciation expense is principally based on the composite group method. Depreciation expense was $350,107,000, $393,826,000 and $422,861,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Effective with the completion of an independent study of the estimated useful lives of our plant assets we adopted new lives beginning October 1, 2006. (5) Retained Earnings - Cumulative Effect Adjustment: -- In September 2006, the SEC staff issued Staff Accounting Bulletin (SAB) Topic 1N (SAB No. 108), "Financial Statements - Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements". SAB No. 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the financial statements are materially misstated. Under this guidance, companies should take into account both the effect of a misstatement on the current year balance sheet as well as the impact upon the current year income statement in assessing the materiality of a current year misstatement. Once a current year misstatement has been quantified, the guidance in SAB Topic 1M, "Financial Statements Materiality," (SAB No. 99) will be applied to determine whether the misstatement is material. SAB No. 108 allows for a one-time transitional cumulative effect adjustment to beginning retained earnings as of January 1, 2006 for errors that were not previously deemed material as they were being evaluated under a single method but are material when evaluated under the dual approach proscribed by SAB No. 108. The Company adopted SAB No. 108 in connection with the preparation of its financial statements for the year ended December 31, 2006. The adoption did not have any impact on the Company's cash flow or prior year financial statements. As a result of adopting SAB No. 108 in the fourth quarter of 2006 and electing to use the one-time transitional cumulative effect adjustment, the Company made adjustments to the beginning balance of retained earnings as of January 1, 2006 in the fourth quarter of 2006 for the following errors (all of which were determined to be immaterial under the Company's previous methodology): F-16 Summary SAB No. 108 entry recorded January 1, 2006: ($ in thousands) Increase/(Decrease) --------------- ------------------- Property, Plant & Equipment $ 1,990 Goodwill (3,716) Other Assets (20,081) ----------- $ (21,807) =========== Current Liabilities $ (2,922) Deferred Taxes (17,339) Other Long-Term Liabilities (13,037) Long-term Debt (24,901) Retained Earnings 36,392 ----------- $ (21,807) =========== Deferred Tax Accounting. As a result of adopting SAB No. 108 in the fourth quarter of 2006 we recorded a decrease in deferred income tax liabilities in the amount of approximately $23.5 million and an increase in retained earnings of approximately $23.5 million as of January 1, 2006. The change in deferred tax and retained earnings is a result of excess deferred tax liabilities that built up in periods prior to 2003 (approximately $4 million in 2003, $5.4 million in 2002 and $14.1 million in 2001 and prior) resulting primarily from differences between actual state income tax rates and the effective composite state rate utilized for estimating the Company's book state tax provisions. Goodwill. During 2002 we estimated and booked impairment charges (pre-tax) of $1.07 billion. We subsequently discovered that the impairment charge recorded was overstated as it exceeded the underlying book value by approximately $8.1 million. The result was an understatement of goodwill. We corrected this error by reversing the negative goodwill balance of $8.1 million with an offset to increase retained earnings. Unrecorded Liabilities. Citizens has changed its accounting policies associated with the accrual of utilities and vacation expense. Historically, the Company's practice was to expense utility and vacation costs in the period these items were paid, which generally resulted in a full year of utilities and vacation expense in the consolidated statements of income. The utility costs will now be accrued in the period used and vacation costs will be accrued in the period earned. The cumulative amount of these changes as of the beginning of fiscal 2006 was approximately $3.0 million and, as

provided in SAB No. 108, the impact was recorded as a reduction of retained earnings as of the beginning of fiscal 2006. We established an accrual of $4.5 million for advance billings associated with certain revenue at two telephone properties that the Company has operated since the 1930's. For these two properties, the Company's records have not reflected the liability. This had no impact on the revenue reported for any of the five years reported in this 10-K. We recorded a liability of $2.5 million to recognize a post retirement annuity payment obligation for two former executives of the Company. The liability should have been established in 1999 at the time the two employees elected to exchange their death benefit rights for an annuity payout in accordance with the terms of their respective split dollar life insurance agreements. We established the liability effective January 1, 2006 in accordance with SAB No. 108 by reducing retained earnings by a like amount. Long-Term Debt. We recorded a reclassification of $20.1 million from other assets to long-term debt. The balance represents debt discounts which the company historically accounted for as a deferred asset. For certain debt issuances the Company amortized the debt discount using the straight line method instead of the effective interest method. We corrected this error by increasing the debt discount by $4.8 million and increasing retained earnings by a like amount. F-17 Customer Advances for Construction. Amounts associated with "construction advances" remaining on the Company's balance sheet ($92.4 million at December 31, 2005) included approximately $7.3 million of such contract advances that were transferred to the purchaser of our water and wastewater operations on January 15, 2002 and accordingly should have been included in the gain recognized upon sale during that period. Upon the adoption of SAB No. 108 in the fourth quarter of 2006, this error was corrected as of January 1, 2006 through a decrease in other long-term liabilities and an increase in retained earnings. Purchase Accounting. During the period 1991 to 2001 Citizens acquired a number of telecommunications businesses, growing its asset base from approximately $400 million in 1991 to approximately $6 billion by the end of 2001. As a result of these acquisitions, we recorded in accordance with purchase accounting standards, all of the assets and liabilities associated with these properties. We have determined that approximately $18.8 million (net) of liabilities were established in error. Approximately $18.0 million of the liabilities should have been recorded as a decrease to goodwill, $4.2 million should have been an increase to property, plant and equipment ($1.99 million after amortization of $2.21 million). In addition, $4.964 million of liabilities should have been reversed in 2001. We corrected this error by reversing the liability to retained earnings. As permitted by the adoption of SAB No. 108 we have adjusted our previously recorded acquisition entries as follows: ($ in thousands, increase/(decrease)) ------------------------------------ Property, Plant & Equipment $ 1,990 Goodwill (18,049) ---------- Assets $ (16,059) ========== Current Liabilities $ (10,468) Other Long-Term Liabilities (8,345) Retained Earnings 2,754 ---------- $ (16,059) ========== Tax Effect. The net effect on taxes (excluding the $23.5 million entry described above) resulting from the adoption of SAB No. 108 was an increase to deferred tax liabilities of $6.2 million and an increase to goodwill of $6.2 million. (6) Accounts Receivable: ------------------- The components of accounts receivable at December 31, 2006 and 2005 are as follows: ($ in thousands) 2006 2005 --------------- ------------- -------------- End user $ 278,891 $ 210,224 Other 17,383 24,231 Less: Allowance for doubtful accounts (108,537) (31,385) ------------- -------------- Accounts receivable, net $ 187,737 $ 203,070 ============== ============== Additions ------------------------------ Balance at Charged to Charged to other Balance at beginning of bad debt accounts- end of Accounts period expense * revenue Deductions period ----------------------------- --- Allowance for doubtful accounts 2004 $ 35,916 $ 17,657 $ 2,215 $ 20,708 $ 35,080 2005 35,080 12,797 1,080 17,572 31,385 2006 31,385 20,257 80,003 23,108 108,537
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* Such amounts are included in bad debt expense and for financial reporting purposes are classified as contra-revenue. F-18 We maintain an allowance for estimated bad debts based on our estimate of collectibility of our accounts receivable. Bad debt expense is recorded as a reduction to revenue. Our reserve has increased by approximately $78,250,000 as a result of carrier activity that is in dispute. Our principal carrier dispute concerns the "origination" of certain calls carried by AT&T Corp. and AT&T Communications, Inc. (collectively, "AT&T") and terminated on

our networks. In January 2006, we filed a complaint against AT&T in the United States District Court for the District of New Jersey with respect to this dispute (which case was consolidated with that of other plaintiffs in February 2006). During the pendency of the dispute we became better able to estimate the true "origination" of the calls and minutes in dispute and back billed AT&T for the difference in rates, including interest. We have reserved substantially all of these amounts. The FCC has denied AT&T's petition regarding its treatment on the "origination" of the specific class of calls but left any resolution of retroactive payments to the parties. In November 2006, AT&T filed counterclaims against us. We have been engaged in settlement negotiations with AT&T. If a settlement is not reached, we will continue to vigorously pursue our case and defend the counterclaims in the federal court. (7) Other Intangibles: ------------------ Other intangibles at December 31, 2006 and 2005 are as follows: ($ in thousands) 2006 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 (684,310) (557,930) -------------- --------------- Total other intangibles, net $ 432,353 $ 558,733 =============== ================ Amortization expense was $126,380,000, $126,378,000 and $126,520,000 for the years ended December 31, 2006, 2005 and 2004, respectively. Amortization expense, based on our estimate of useful lives, is estimated to be $126,380,000 per year through 2008 and $57,535,000 in 2009, at which point the customer base will have been fully amortized. (8) Discontinued Operations: ----------------------- (a) Electric Lightwave ------------------ On July 31, 2006, we sold our CLEC business, Electric Lightwave LLC (ELI), for $255.3 million in cash plus the assumption of approximately $4.0 million in capital lease obligations. We recognized a pre-tax gain on the sale of ELI of approximately $116.7 million. Our after-tax gain on the sale was $71.6 million. Our cash liability for taxes as a result of the sale is expected to be approximately $5.0 million due to the utilization of existing tax net operating losses on both the federal and state level. In accordance with SFAS No. 144, any component of our business that we dispose of or classify as held for sale that has operations and cash flows clearly distinguishable from operations, and for financial reporting purposes, and that will be eliminated from the ongoing operations, should be classified as discontinued operations. Accordingly, we have classified the results of operations of ELI as discontinued operations in our consolidated statements of operations and have restated prior periods. We ceased to record depreciation expense effective February 2006. F-19 Summarized financial information for ELI (discontinued operations) is set forth below: ($ in thousands) For the years ended December 31, ---------------- -- 2006 2005 2004 ----------------- ----------------- ----------------- Revenue $ 100,612 $ 159,161 $ 156,030 Operating income $ 27,882 $ 21,480 $ 16,621 Income taxes $ 11,583 $ 9,070 $ 6,175 Net income $ 18,912 $ 12,226 $ 9,855 Gain on disposal, net of tax $ 71,635 $ - $ - December 31, December 31, ($ in thousands) 2006 2005 ---------------- ---------------- ----------------- (Sold) Current assets $ 24,986 Net property, plant and equipment 137,730 ----------------- Total assets of discontinued operations $ 162,716 ================= Current liabilities $ 21,605 Long term liabilities 24,661 ----------------- Total liabilities of discontinued operations $ 46,266 ================= (b) Conference Call USA ------------------- In February 2005, we entered into a definitive agreement to sell Conference-Call USA, LLC (CCUSA), our conferencing services business. On March 15, 2005, we completed the sale for $43,565,000 in cash. The pre-tax gain on the sale of CCUSA was $14,061,000. Our after-tax gain was approximately $1,167,000. The book income taxes recorded upon sale are primarily attributable to a low tax basis in the assets sold. In accordance with SFAS No. 144, any component of our business that we dispose of or classify as held for sale that has operations and cash flows clearly distinguishable from operations, and for financial reporting purposes, and that will be eliminated from the ongoing operations, should be classified as discontinued operations. Accordingly, we have classified the results of operations of CCUSA as discontinued operations in our consolidated statements of operations and have restated prior periods. The company had no outstanding debt specifically identified with CCUSA and therefore no interest expense was allocated to discontinued operations. In addition, we ceased to record depreciation expense effective February 16, 2005. Summarized financial information for CCUSA (discontinued operations) is set forth below: ($ in thousands) For the

years ended December 31, ---------------- -- 2006 2005 2004 ----------------- ----------------- ----------------- Revenue (Sold) $ 4,607 $ 24,558 Operating income $ 1,489 $ 8,188 Income taxes $ 449 $ 2,957 Net income $ 1,040 $ 5,231 Gain on disposal of CCUSA, net of tax $ 1,167 $ - There was no balance sheet data to report for CCUSA as of December 31, 2006 or 2005. (c) Public Utilities ---------------- On April 1, 2004, we completed the sale of our Vermont electric distribution operations for approximately $13,992,000 in cash, net of selling expenses. With that transaction, we completed the divestiture of our public utilities services business pursuant to plans announced in 1999. F-20 (9) Investments: ----------- The components of investments at December 31, 2006 and 2005 are as follows: ($ in thousands) 2006 2005 ---------------- ---------------- ---------------- Marketable equity securities $ 30 $ 122 Equity method investments 16,444 15,877 ---------------- ---------------- $ 16,474 $ 15,999 ================ ================ Marketable Securities As of December 31, 2006 and 2005, we owned 3,059,000 shares of Adelphia Communications Corp. (Adelphia) common stock. As a result of write downs recorded in 2002 and 2001, our "book cost basis" was reduced to zero and subsequent increases and decreases, except for those deemed other than temporary, are included in accumulated other comprehensive income (loss). Unrealized holding gains at December 31, 2006 and 2005 were $30,000 and $122,000 respectively which approximates the fair market value. During 2004, we sold our investments in D & E Communications, Inc. (D & E) and Hungarian Telephone and Cable Corp. (HTCC) for approximately $13,300,000 and $13,200,000 in cash, respectively. We recorded net realized gains of $12,066,000 in our statement of operations for the sale of these marketable securities. At December 31, 2006 and 2005, we did not have any investments that have been in a continuous unrealized loss position deemed to be temporary for more than 12 months. We determined that market fluctuations during the period are not other than temporary because the severity and duration of the unrealized losses were not significant. Equity Method Investments Our investments in entities that are accounted for under the equity method of accounting consist of the following: (1) a 16.8% interest in the Fairmount Cellular Limited Partnership which is engaged in cellular mobile telephone service in the Rural Service Area (RSA) designated by the FCC as Georgia RSA No. 3; and (2) our investments in CU Capital and CU Trust with relation to our convertible preferred securities. The investments in these entities amounted to $16,444,000 and $15,877,000 at December 31, 2006 and 2005, respectively. (10) Fair Value of Financial Instruments: ----------------------------------- The following table summarizes the carrying amounts and estimated fair values for certain of our financial instruments at December 31, 2006 and 2005. For the other financial instruments, representing cash, accounts receivables, long-term debt due within one year, accounts payable and other accrued liabilities, the carrying amounts approximate fair value due to the relatively short maturities of those instruments. The fair value of our marketable securities and long-term debt is estimated based on quoted market prices at the reporting date for those financial instruments. Other securities and investments for which market values are not readily available are carried at cost. ($ in thousands) 2006 2005 ---------------- --------------------------------- --------------------------------- Carrying Carrying Amount Fair Value Amount Fair Value ---------------- ----------------- ---------------- ---------------- Investments $ 16,474 $ 16,474 $ 15,999 $ 15,999 Long-term debt (1) $ 4,460,755 $ 4,620,921 $ 3,995,130 $ 4,022,960 (1) 2006 and 2005 includes interest rate swaps of ($10,289,000) and ($8,727,000), respectively. 2006 and 2005 includes EPPICS of $17,860,000 and $33,785,000, respectively. F-21 (11) Long-term Debt: -------------- The activity in our long-term debt from December 31, 2005 to December 31, 2006 is summarized as follows: Twelve Months Ended --- Interest Rate* at December 31, New Rate December 31, December 31, ($ in thousands) 2005 Payments Borrowings Swap Other 2006 2006 ---------------- Rural Utilities Service Loan Contracts $ 22,809 $ (923) $ - $ - $ - $ - $ 21,886 6.080% Senior Unsecured Debt 4,120,781 (226,770) 550,000 (1,562) (7,431) 4,435,018 8.296% EPPICS (see Note 15) 33,785 - - - (15,925) 17,860 5.000% Industrial Development Revenue Bonds 58,140 - - - - 58,140 5.559% ------------ ---------- ---------- --------- --------- ----------- TOTAL LONG TERM DEBT $4,235,515 $(227,693) $550,000 $ (1,562) $(23,356) $4,532,904 ------------ ========= ========= ========= ========= ========= ----------- Less: Debt Discount (12,692) (32,878) Less: Current Portion (227,693) (39,271) ------------ ----------- $3,995,130

$4,460,755 =========== ========== * Interest rate includes amortization of debt issuance expenses, debt premiums or discounts. The interest rate for Rural Utilities Service Loan Contracts, Senior Unsecured Debt, and Industrial Development Revenue Bonds represent a weighted average of multiple issuances. Additional information regarding our Senior Unsecured Debt at December 31: 2006 2005 -------------------------------- -------------------------------- Principal Interest Principal Interest ($ in thousands) Outstanding Rate Outstanding Rate ---------------- ---------------- ------------ ---------------- ------------ Senior Notes: Due 8/17/2006 $ - - $ 51,770 6.758% Due 8/15/2008 495,240 7.625% 699,990 7.625% Due 5/15/2011 1,050,000 9.250% 1,050,000 9.250% Due 10/24/2011 200,000 6.270% 200,000 6.270% Due 12/31/2012 150,000 6.75% (variable) - - Due 1/15/2013 700,000 6.250% 700,000 6.250% Due 1/15/2027 400,000 7.875% - - Due 8/15/2031 945,325 9.000% 748,006 9.000% ---------------- ---------------- 3,940,565 3,449,766 Debentures due 2025 - 2046 468,742 7.136% 643,742 7.263% Subsidiary Senior Notes due 12/1/2012 36,000 8.050% 36,000 8.050% Fair value of interest rate swaps (10,289) (8,727) ---------------- ---------------- Total $ 4,435,018 $ 4,120,781 ================= ================= For the year ended December 31, 2006, we retired an aggregate principal amount of $251.0 million of debt, including $15.9 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. During the fourth quarter of 2006, we entered into four debt-for-debt exchanges and exchanged $157.3 million of our 7.625% notes due 2008 for $149.9 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, with respect to the first quarter debt exchanges, 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. F-22 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. On August 17, 2006, we retired at par the $29.1 million remaining balance of the 6.75% Senior Notes. 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 December 31, 2006, we have not made any purchases pursuant to this authorization. On December 22, 2006, we issued in a private placement, an aggregate $400.0 million principal amount of 7.875% Senior Notes due January 15, 2027. Proceeds from the sale are expected to be used to partially finance our acquisition of Commonwealth Telephone or if the acquisition is not completed, to purchase, redeem or otherwise retire a portion of our outstanding debt. We have agreed to file with the SEC a registration statement for the purpose of exchanging these notes for registered notes. In December 2006, we borrowed $150.0 million under a senior unsecured term loan agreement. The loan matures in 2012 and bears interest based on an average prime rate or London Interbank Offered Rate or LIBOR plus 1 3/8%, at our election. We intend to use the proceeds to repurchase a portion of our outstanding debt or to partially finance the Commonwealth acquisition. As of December 31, 2006, EPPICS representing a total principal amount of $193.9 million had been converted into 15.6 million shares of our common stock, and a total of $7.4 million remains outstanding to third parties. Our long term debt footnote indicates $17.9 million of EPPICS outstanding at December 31, 2006, of which $10.5 million is debt of related parties for which the Company has an offsetting receivable. We had a total outstanding principal amount of industrial development revenue bonds of $58,140,000 at December 31, 2006 and 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. These bonds' first call dates 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 7, 2007. We expect to call the bonds and retire them with cash. As of December 31, 2006 we had available lines of credit with financial institutions in the aggregate amount of $249,600,000 with a maturity date of October 29, 2009. Outstanding standby letters of credit issued under the facility were $0.4 million. Associated facility fees vary depending on our leverage ratio and were 0.375% as of December 31, 2006. During the term of the credit facility we may borrow, repay and re-borrow funds. The credit facility is available for general corporate purposes but may not be used to fund dividend payments. For the year ended December 31, 2005, we retired an aggregate principal amount of $36.4 million of debt, including $30.0 million of 5% Company Obligated Mandatorily Redeemable Convertible Preferred Securities due 2036 (EPPICS) that were converted into our common stock. During the second quarter of 2005, we entered into two debt-for-debt exchanges of our debt securities. As a result, $50.0 million of our 7.625% notes due 2008 were exchanged for approximately $52.2 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 $3.2 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. F-23 For the year ended December 31, 2004, we retired an aggregate $1,350,397,000 of debt (including $147,991,000 of EPPICS conversions), representing approximately 28% of total debt outstanding at December 31, 2003. The retirements generated a pre-tax loss on the early extinguishment of debt at a premium of approximately $66,480,000 recorded in other income (loss), net. We are in compliance with all of our debt and credit facility covenants. Our principal payments for the next five years are as follows: ($ in thousands) --------------- Principal Payments --------- 2007 39,271 2008 497,688 2009 2,507 2010 5,886 2011 1,252,517 (12) Derivative Instruments and Hedging Activities: --- 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 sheets 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. Changes in the fair value of interest rate swap contracts, and the offsetting changes in the adjusted carrying value of the related portion of the fixed-rate debt being hedged, are recognized in the consolidated statements of operations in interest expense. The notional amounts of interest rate swap contracts hedging fixed-rate indebtedness as of December 31, 2006 and December 31, 2005 were $550,000,000 and $500,000,000, respectively. Such contracts require us to pay variable rates of interest (average pay rates of approximately 9.02% and 8.60% as of December 31, 2006 and 2005, respectively) and receive fixed rates of interest (average receive rates of 8.26% and 8.46% as of December 31, 2006 and 2005, respectively). The fair value of these derivatives is reflected in other liabilities as of December 31, 2006 and 2005, in the amount of ($10,289,000) and ($8,727,000), respectively. The related underlying debt has been decreased in 2006 and 2005 by a like amount. For the year ended December 31, 2006 , the interest expense resulting from these interest rate swaps totaled approximately $4.2 million. For the years ended December 31, 2005 and 2004 our interest expense was reduced by $2.5 million and $9.4 million, respectively. We do not anticipate any nonperformance by counter-parties to our derivative contracts as all counter-parties have investment grade credit ratings. (13) Management Succession and Strategic Alternatives Expenses: -- On July 11, 2004, our Board of Directors announced that it had completed its review of our

financial and strategic alternatives, and on September 2, 2004, we paid a special, non-recurring dividend of $2.00 per common share and a quarterly dividend of $0.25 per common share to shareholders of record on August 18, 2004. Concurrently, Leonard Tow decided to step down from his position as chief executive officer, effective immediately, and resigned his position as Chairman of the Board on September 27, 2004. The Board of Directors named Mary Agnes Wilderotter president and chief executive officer in November 2004. F-24 In 2004, we expensed approximately $90,632,000 of costs related to management succession and our exploration of financial and strategic alternatives. Included are $36,618,000 of non-cash expenses for the acceleration of stock benefits, cash expenses of $19,229,000 for advisory fees, $19,339,000 for severance and retention arrangements and $15,446,000 primarily for tax reimbursements. (14) Investment Income and Other Income (Loss), net: -- During 2006 we recognized a gain of $61.4 million (recorded in investment income) arising from the liquidation and dissolution of the RTB. The components of other income (loss), net for the years ended December 31, 2006, 2005 and 2004 are as follows: ($ in thousands) 2006 2005 2004 ---------------- ---------------- ---------------- ----------------- Legal contingencies $ (1,000) $ (7,000) $ - Gain on expiration/settlement of customer advances 3,539 681 25,345 Loss on exchange of debt (2,433) (3,175) - Premium on debt repurchases - - (66,480) Minority share of Mohave Cellular net income (4,164) (3,599) (817) Gain on forward rate agreements 430 1,851 - Loss on sale of assets - - (1,945) Other, net 2,501 9,881 (9,568) ----------------- ----------------- ----------------- Total other income (loss), net $ (1,127) $ (1,361) $ (53,465) ================= ================= ================= During 2006 and 2005, we recorded expense in connection with the Bangor, Maine legal matter. In connection with our exchange of debt during the first quarter of 2006 and second quarter of 2005, we recognized a non-cash, pre-tax loss. 2006 and 2005 also include a gain for the changes in fair value of our forward rate agreements. During 2006, 2005 and 2004, we recognized income in connection with certain retained liabilities, that have terminated, associated with customer advances for construction from our disposed water properties. Pre-tax gains (losses) in connection with the following transactions were recorded in other income (loss), net: 2005 ---- On February 1, 2005, we sold shares of Prudential Financial, Inc. for approximately $1,112,000 in cash, and we recognized a pre-tax gain of approximately $493,000. 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 $24,195,000, and we recognized a pre-tax gain of approximately $457,000. During 2005, we sold shares of Global Crossing Limited for approximately $1,084,000 in cash, and we recognized a pre-tax gain for the same amount. 2004 ---- In October 2004, we sold cable assets in California, Arizona, Indiana, and Wisconsin for approximately $2,263,000 in cash. The pre-tax gain on the sale was $40,000. During the third quarter of 2004, we sold our corporate aircraft for approximately $15,298,000 in cash. The pre-tax loss on the sale was $1,087,000. F-25 (15) 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 convert into our common stock at 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 four quarters of 2006, 2005 and 2004. 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 December 31, 2006, EPPICS representing a total principal amount of $193,896,000 had been converted into 15,626,965 shares of our common stock. A total of $7,354,000 of EPPICS is outstanding as of December 31, 2006 and if all outstanding EPPICS were converted, 641,485 shares of our common stock would be issued upon such conversion. Our long-term debt footnote indicates $17,860,000 of EPPICS outstanding at December 31, 2006, of which $10,500,000 is debt of related parties for which the company has an offsetting receivable. We adopted the provisions of FIN No. 46R (revised December 2003) (FIN No. 46R), "Consolidation of Variable Interest Entities," effective January 1, 2004. Accordingly, the Trust holding the EPPICS and the related Citizens Utilities Capital L.P. are deconsolidated. (16) Capital Stock: -------------- We are authorized to issue up to 600,000,000 shares of common stock. The amount and timing of dividends payable on common stock are, subject to applicable law, within the sole discretion of our Board of Directors. (17) Stock Plans: ------------ At December 31, 2006, we had five stock-based compensation plans under which grants have been made and awards remained outstanding. These plans, which are described below are the Management Equity Incentive Plan (MEIP), the 1996 Equity Incentive Plan (1996 EIP), the Amended and Restated 2000 Equity Incentive Plan (2000 EIP), the Non-Employee Directors' Deferred Fee Plan (Deferred Fee Plan) and the Non-Employee Directors' Equity Incentive Plan (Director's Equity Plan, and together with the Deferred Fee plan, the Director Plans). 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 No. 25, we were not required to recognize compensation expense for the cost of stock options. In accordance with the adoption of SFAS No. 123R, we recorded stock-based compensation expense for 2006 in the amount of $2,230,000 for the cost of stock options. Our general policy is to issue shares upon the grant of restricted shares and exercise of options from treasury. At December 31, 2006, there were 29,930,472 shares authorized for grant under these plans and 5,871,730 shares available for grant. No further awards may be granted under the MEIP, the 1996 EIP and the Deferred Fee plan. F-26 In connection with the Director Plans, compensation costs associated with the issuance of stock units was $2,017,000, $1,069,000 and $2,222,000 in 2006, 2005 and 2004, respectively. Cash compensation associated with this plan was $502,000, $434,000 and $642,000 in 2006, 2005 and 2004, respectively. These costs are recognized in other operating expenses. We have granted restricted stock awards to key employees in the form of our common stock. The number of shares issued as restricted stock awards during 2006, 2005 and 2004 were 732,000, 352,000 and 2,172,000, respectively. None of the restricted stock awards may be sold, assigned, pledged or otherwise transferred, voluntarily or involuntarily, by the employees until the restrictions lapse, subject to limited exceptions. The restrictions are time based. At December 31, 2006, 1,174,000 shares of restricted stock were outstanding. Compensation expense, recognized in operating expense, of $6,034,000, $7,358,000 and $45,313,000, for the years ended December 31, 2006, 2005 and 2004, respectively, has been recorded in connection with these grants. Management Equity Incentive Plan ------------------------------- Prior to its expiration on June 21, 2000, awards of our common stock could have been granted under the MEIP 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 of the MEIP, no awards have been or may 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 were not ordinarily exercisable on the date of grant but vest over a period of

time (generally four 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. 1996 and 2000 Equity Incentive Plans ---------------------------------- Since the expiration date of the 1996 EIP on May 22, 2006, no awards have been or may 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, SAR's, 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 December 31, 2006, there were 27,389,711 shares authorized for grant under the 2000 EIP and 3,385,785 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 four years). Under the terms of the EIPs, 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. In connection with the payment of the special, non-recurring dividend of $2.00 per common share on September 2, 2004, the exercise price and number of all outstanding options was adjusted such that each option had the same value to the holder after the dividend as it had before the dividend. In accordance with FASB Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions Involving Stock Compensation" and EITF No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB No. 25 and FIN No. 44," there is no accounting consequence for changes made to the exercise price and the number of shares of a fixed stock option or award as a direct result of the special, non-recurring dividend. F-27 The following summary presents information regarding outstanding stock options and changes with regard to options under the MEIP and EIP plans: Weighted Weighted Aggregate Shares Average Average Intrinsic Subject to Option Price Remaining Value at Option Per Share Life in Years December 31 --- -------------------- -------------- ------------------ ------------------ Balance at January 1, 2004 17,965,000 $11.94 Options granted - - Options exercised (7,411,000) 9.69 $29,002,000 Options canceled, forfeited or lapsed (355,000) 12.14 Effect of special, non-recurring dividend 2,212,000 - -- --------------------- Balance at December 31, 2004 12,411,000 11.15 6.11 $38,162,000 Options granted 183,000 11.58 Options exercised (4,317,000) 10.52 $12,730,000 Options canceled, forfeited or lapsed (292,000) 10.48 -- --------------------- Balance at December 31, 2005 7,985,000 11.52 5.32 $13,980,000 Options granted 22,000 12.55 Options exercised (2,695,000) 9.85 $ 9,606,000 Options canceled, forfeited or lapsed (70,000) 10.13 -- --------------------- Balance at December 31, 2006 5,242,000 $12.41 4.36 $14,490,000 == ===================== The following table summarizes information about shares subject to options under the MEIP and EIP plans at December 31, 2006: Options Outstanding Options Exercisable -- -------------------------------- Weighted Average Weighted Number Range of Weighted Average Remaining Number Average Outstanding Exercise Prices Exercise Price Life in Years Exercisable Exercise Price ----------------- ------------------- -------------------- -------------------- -- ---------------- --------------- 327,000 $ 6.45 - 6.67 $ 6.51 1.94 327,000 $ 6.51 149,000 7.33 - 7.98 7.37 0.75 149,000 7.37 581,000 8.19 - 8.19 8.19 5.38 581,000 8.19 29,000 8.53 - 9.68 8.96 1.53 29,000 8.96 900,000 10.44 - 10.44 10.44 6.41 483,000 10.44 379,000 11.15 - 11.15 11.15 3.80 379,000 11.15 740,000 11.79 - 11.79 11.79 4.38 740,000 11.79 2,137,000 11.90 - 18.46 16.13 3.99 2,103,000 16.18 ----------------- ---------------- 5,242,000 $ 6.45 - 18.46 $12.41 4.36 4,791,000 $12.58 ================= ================= The number of options exercisable at December 31, 2005 and 2004 were 6,548,000 and 9,235,000, with a weighted average exercise price of $11.92 and $11.57, respectively. Cash received

upon the exercise of options during 2006, 2005 and 2004 was $27,200,000, $47,550,000 and $84,522,000 respectively. Total remaining unrecognized compensation cost associated with unvested stock options at December 31, 2006 was $771,000 and the weighted average period over which this cost is expected to be recognized is approximately one year. 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. F-28 The following table presents the weighted average assumptions used for grants in 2006 and 2005. There were no option grants during 2004. 2006 2005 -------------------------- --------------- -------------- Dividend yield 7.55% 7.72% Expected volatility 44% 46% Risk-free interest rate 4.89% 4.16% Expected life 5 years 6 years -------------------------- --------------- -------------- The following summary presents information regarding unvested restricted stock and changes with regard to restricted stock under the MEIP and the EIPs: Weighted Aggregate Average Fair Value at Number of Grant Date December 31, Shares Fair Value 2006 -- -------------------- -------------- ------------------ Balance at January 1, 2004 1,159,000 $10.18 Restricted stock granted 2,172,000 12.68 $29,953,000 Restricted stock vested (1,638,000) 11.32 $22,592,000 Restricted stock forfeited (7,000) 12.59 -- -------------------- Balance at December 31, 2004 1,686,000 12.29 $23,253,000 Restricted stock granted 352,000 13.11 $ 4,305,000 Restricted stock vested (491,000) 12.27 $ 6,000,000 Restricted stock forfeited (91,000) 12.58 -- -------------------- Balance at December 31, 2005 1,456,000 12.47 $17,808,000 Restricted stock granted 732,000 12.87 $10,494,000 Restricted stock vested (642,000) 12.08 $ 9,226,000 Restricted stock forfeited (372,000) 12.60 -- -------------------- Balance at December 31, 2006 1,174,000 $12.89 $16,864,000 == ==================== 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 December 31, 2006 was $9,934,000 and the weighted average period over which this cost is expected to be recognized is approximately two years. Non-Employee Directors' Compensation Plans -- Upon commencement of his or her service on the Board of Directors, each non-employee director receives a grant of 10,000 stock options. 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 and prior to effectiveness of that plan, were awarded under the Deferred Fee plan. Since the effectiveness of the Director's Equity Plan, no further grants have been made under the Deferred Fee Plan. Prior to April 20, 2004, each non-employee director received an award of 5,000 stock options. The exercise price of such options was set at 100% of the fair market value on the date the options were granted. The options are exercisable six months after the grant date and remain exercisable for ten years after the grant date. F-29 In addition, each year, each non-employee director is also entitled to receive a retainer, meeting fees, and, when applicable, fees for serving as a committee chair or as Lead Director, which are awarded under the Directors' Equity Plan. For 2006, each non-employee director had to elect, by December 31 of the preceding year, to receive $40,000 cash or 5,760 stock

units as an annual retainer. Directors making a stock unit election must also elect to convert the units to either common stock (convertible on a one-to-one basis) or cash upon retirement or death. Prior to June 30, 2003, a director could elect to receive 20,000 stock options as an annual retainer in lieu of cash or stock units. The exercise price of the stock options was set at the average of the high and low market prices of our common stock on the date of grant. The options were exercisable six months after the date of grant and had a 10-year term. The number of shares of common stock authorized for issuance under the Directors' Equity Plan is 2,540,761, which includes 540,761 shares that were 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 December 31, 2006, there were 2,485,945 shares available for grant. There were 13 directors participating in the Directors' Plans during all or part of 2006. In 2006, the total options, plan units, and stock earned were 20,000, 81,000 and 0, respectively. In 2005, the total options, plan units, and stock earned were 70,000, 64,000 and 0, respectively. In 2004, the total options, plan units, and stock earned were 50,000, 57,226 and 0, respectively. Options granted prior to the adoption of the Director's Equity Plan were granted under the 2000 EIP. At December 31, 2006, 157,908 options were exercisable at a weighted average exercise price of $11.97. For 2006, each non-employee director received fees of $2,000 for each in-person Board of Directors and committee meeting attended and $1,000 for each telephone Board and committee meeting attended. The chairs of the Audit, Compensation, Nominating and Corporate Governance and Retirement Plan Committees were paid an additional annual fee of $25,000, $15,000, $7,500 and $5,000, respectively. In addition, the Lead Director, who heads the ad hoc committee of non-employee directors, received an additional annual fee of $15,000. A director must elect, by December 31 of the preceding year, to receive meeting and other fees in cash, stock units, or a combination of both. All fees paid to the non-employee directors in 2006 were paid quarterly. If the director elects stock units, the number of units credited to the director's account is determined as follows: the total cash value of the fees payable to the director are divided by 85% of the closing prices of our common stock on the last business day of the calendar quarter in which the fees or stipends were earned. Units are credited to the director's account quarterly. We account for the Deferred Fee Plan and Directors' Equity Plan in accordance with SFAS No. 123R. To the extent directors elect to receive the distribution of their stock unit account in cash, they are considered liability-based awards. To the extent directors elect to receive the distribution of their stock unit accounts in common stock, they are considered equity-based awards. Compensation expense for stock units that are considered equity-based awards is based on the market value of our common stock at the date of grant. Compensation expense for stock units that are considered liability-based awards is based on the market value of our common stock at the end of each period. 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. 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 December 31, 2006, the liability for such payments was $686,000 all of which will be payable in stock (based on the July 15, 1999 stock price). (18) Restructuring and Other Expenses: -------------------------------- 2006, 2005 and 2004 ------------------- During 2006, 2005 and 2004, we did not recognize any restructuring and other expenses. We continue to review our operations, personnel and facilities to achieve greater efficiency. F-30 (19) Income Taxes: ------------- The following is a reconciliation of the provision for

income taxes for continuing operations computed at federal statutory rates to the effective rates for the years ended December 31, 2006, 2005 and 2004: 2006 2005 2004 ------------ ----------- ----------- Consolidated tax provision at federal statutory rate 35.0 % 35.0 % 35.0 % State income tax provisions, net of federal income tax benefit 2.1 % 1.6 % 1.4 % Tax reserve adjustment 0.2 % (8.2)% (22.5)% All other, net (2.4)% 0.2 % (7.0)% ------------ ----------- ----------- 34.9 % 28.6 % 6.9 % ============ ========== ========== The components of the net deferred income tax liability (asset) at December 31 are as follows: ($ in thousands) 2006 2005 ---------------- ------------ ----------- Deferred income tax liabilities: ------------------------------- Property, plant and equipment basis differences $ 547,726 $ 571,956 Intangibles 175,991 168,703 Other, net 9,675 3,207 ------------ ----------- 733,392 743,866 ------------ ----------- Deferred income tax assets: -------------------------- Minimum pension liability - 76,368 FASB 158 pension/OPEB liability 51,660 - Tax operating loss carryforward 81,515 260,053 Alternate minimum tax credit carryforward 54,834 43,678 Employee benefits 70,013 66,853 Other, net 24,039 21,279 ------------ ----------- 282,061 468,231 Less: Valuation allowance (49,679) (38,131) ------------ ----------- Net deferred income tax asset 232,382 430,100 ------------ ----------- Net deferred income tax liability $ 501,010 $ 313,766 ============ ========== Deferred tax assets and liabilities are reflected in --- the following captions on the balance sheet: --- Deferred income taxes $ 514,130 $ 325,084 Other current assets (13,120) (11,318) ------------ ----------- Net deferred income tax liability $ 501,010 $ 313,766 ============ ========== Our federal and state tax operating loss carryforwards as of December 31, 2006 are estimated at $56,636,000 and $1,186,873,000, respectively. Our federal loss carryforward will expire in the year 2025. A portion of our state loss carryforward will begin to expire in 2007. Our alternative minimum tax credit as of December 31, 2006 can be carried forward indefinitely to reduce future regular tax liability. F-31 The provision (benefit) for federal and state income taxes, as well as the taxes charged or credited to shareholders' equity, includes amounts both payable currently and deferred for payment in future periods as indicated below: ($ in thousands) 2006 2005 2004 ---------------- ------------ ----------- ----------- Income taxes charged (credited) to the income statement for continuing operations: Current: Federal $ 772 $ 16,708 $ (9,951) State 3,676 (33,006) (3,643) ------------ ----------- ----------- Total current 4,448 (16,298) (13,594) Deferred: Federal 128,534 89,446 21,183 Federal tax credits - (18) (40) State 3,497 2,140 (3,302) ------------ ----------- ----------- Total deferred 132,031 91,568 17,841 ------------ ----------- ----------- Subtotal income taxes for continuing operations 136,479 75,270 4,247 Income taxes charged to the income statement for discontinued operations: Current: Federal 3,018 - - State 2,004 2 3 ------------ ----------- ----------- Total current 5,022 2 3 Deferred: Federal 47,732 18,871 8,219 State 3,835 3,538 910 ------------ ----------- ----------- Total deferred 51,567 22,409 9,129 ------------ ----------- ----------- Subtotal income taxes for discontinued operations 56,589 22,411 9,132 ------------ ----------- ----------- Total income taxes charged to the income statement (a) 193,068 97,681 13,379 Income taxes charged (credited) to shareholders' equity: Deferred income taxes (benefits) on unrealized/realized gains or losses on securities classified as available-for-sale (35) (411) (10,982) Current benefit arising from stock options exercised and restricted stock (3,777) (5,976) (13,765) Deferred income taxes (benefits) arising from the recognition of additional pension/OPEB liability 24,707 (13,933) (6,645) Deferred tax benefit from recording adjustments from the adoption of SAB 108 (17,339) - - ------------ ----------- ----------- Income taxes charged (credited) to shareholders' equity (b) 3,556 (20,320) (31,392) ------------ ----------- ----------- Total income taxes: (a) plus (b) $ 196,624 $ 77,361 $(18,013) ============ ========== =========== F-32 (20) Net Income Per Common Share: --------------------------- The reconciliation of the net income per common share calculation for the years ended December 31, 2006, 2005 and 2004 is as follows: ($ in thousands, except per-share amounts) --- 2006 2005 2004 ------------------ ------------------ ------------------ Net income used for basic and diluted earnings per common share: Income from continuing operations $ 254,008 $ 187,942 $ 57,064 Income from discontinued operations 90,547 14,433 15,086 ------------------ ------------------ ------------------ Total basic net income available for common shareholders $ 344,555 $ 202,375 $ 72,150 ------------------ ------------------ ------------------ Effect of conversion

of preferred securities 401 1,255 - ------------------ ------------------ ------------------ Total diluted net income available for common shareholders $ 344,956 $ 203,630 $ 72,150 ================== ================== ================== Basic earnings per common share: Weighted-average shares outstanding - basic 322,641 337,065 303,989 ================== ================== ================== Income from continuing operations $ 0.79 $ 0.56 $ 0.19 Income from discontinued operations 0.28 0.04 0.05 ------------------ ------------------ ------------------ Net income per share available for common shareholders $ 1.07 $ 0.60 $ 0.24 ================== ================== ================== Diluted earnings per common share: Weighted-average shares outstanding 322,641 337,065 303,989 Effect of dilutive shares 931 1,417 5,194 Effect of conversion of preferred securities 973 3,193 - ------------------ ------------------ ------------------ Weighted-average shares outstanding - diluted 324,545 341,675 309,183 ================== ================== ================== Income from continuing operations $ 0.78 $ 0.56 $ 0.18 Income from discontinued operations 0.28 0.04 0.05 ------------------ ------------------ ------------------ Net income per share available for common shareholders $ 1.06 $ 0.60 $ 0.23 ================== ================== ================== Stock Options ------------- For the years ended December 31, 2006, 2005 and 2004 options of 1,917,000 (at exercise prices ranging from $13.45 to $18.46), 1,930,000 and 2,495,000 (at exercise prices ranging from $13.09 to $18.46), respectively, issuable under employee compensation plans were excluded from the computation of diluted earnings per share (EPS) for those periods as the effect would be antidilutive. In calculating diluted EPS we apply the treasury stock method and include future unearned compensation as part of the assumed proceeds. In connection with the payment of the special, non-recurring dividend of $2.00 per common share on September 2, 2004, the exercise price and number of all outstanding options was adjusted such that each option had the same value to the holder after the dividend as it had before the dividend. In accordance with FASB Interpretation No. 44 (FIN No. 44), "Accounting for Certain Transactions involving Stock Compensation" and EITF No. 00-23, "Issues Related to the Accounting for Stock Compensation under APB No. 25 and FIN No. 44," there is no accounting consequence for changes made to the exercise price and the number of shares of a fixed stock option or award as a direct result of the special, non-recurring dividend. In addition, for the years ended December 31, 2006, 2005 and 2004, restricted stock awards of 1,174,000, 1,456,000 and 1,686,000 shares, respectively, are excluded from our basic weighted average shares outstanding and included in our dilutive shares until the shares are no longer contingent upon the satisfaction of all specified conditions. F-33 Equity Units and EPPICS ----------------------- On August 17, 2004 we issued 32,073,633 shares of common stock, including 3,591,000 treasury shares, to our equity unit holders in settlement of the equity purchase contract component of the equity units. With respect to the $460,000,000 Senior Note component of the equity units, we repurchased $300,000,000 principal amount of these Notes in July 2004. The remaining $160,000,000 of the Senior Notes were repriced and a portion was remarketed on August 12, 2004 as the 6.75% Notes due August 17, 2006. During 2004, we repurchased an additional $108,230,000 of the 6.75% Notes which, in addition to the $300,000,000 purchased in July, resulted in a pre-tax charge of approximately $20,080,000 during the third quarter of 2004. At December 31, 2006 and 2005, we had 147,079 and 465,588 shares, respectively, of potentially dilutive EPPICS, which were convertible into common stock at an exercise price of $11.46 per share. If all EPPICS that remain outstanding are converted, we would issue approximately 641,485 shares of our common stock. As a result of the September 2004 special, non-recurring dividend, the EPPICS exercise price for conversion into common stock was reduced from $13.30 to $11.46. These securities have been included in the diluted income per common share calculation for the period ended December 31, 2006 and 2005. However, 1,065,171 shares for 2004 have not been included in the diluted income per share calculation for the period ended December 31, 2004 because their inclusion would have had an antidilutive effect. Stock Units ---------- At December 31, 2006, 2005 and 2004, we had 319,423, 206,630, and 464,879 stock units, respectively, issued under our Directors' Deferred Fee Equity Plan and Non-Employee Directors' Retirement Plan. These securities have not been included in the diluted income per share calculation because their inclusion would have had an antidilutive effect. (21) Comprehensive Income (Loss):

--------------------------- Comprehensive income consists of net income (loss) and other gains and losses affecting shareholder's investment and FAS No. 158 pension/OPEB liabilities that, under GAAP, are excluded from net income (loss). F-34 Our other comprehensive income (loss) for the years ended December 31, 2006, 2005 and 2004 is as follows: 2006 --- Before-Tax Tax Expense/ Net-of-Tax ($ in thousands) Amount (Benefit) Amount ---------------- -------------- --------------- ------------- Net unrealized holding losses on securities arising during period $ (92) $ (35) $ (57) FAS No. 158 pension/OPEB liability 199,653 74,619 125,034 -------------- --------------- ------------- Other comprehensive income $ 199,561 $ 74,584 $ 124,977 ============== =============== ============= 2005 --- Before-Tax Tax Expense/ Net-of-Tax ($ in thousands) Amount (Benefit) Amount ---------------- -------------- --------------- ------------- Net unrealized holding losses on securities arising during period $ (1,055) $ (395) $ (660) Minimum pension liability (36,416) (13,933) (22,483) Less: Reclassification adjustments for net gains on securities realized in net income (537) (7) (530) -------------- --------------- ------------- Other comprehensive (loss) $ (38,008) $ (14,335) $ (23,673) ============== =============== ============= 2004 --- Before-Tax Tax Expense/ Net-of-Tax ($ in thousands) Amount (Benefit) Amount ---------------- -------------- --------------- ------------- Net unrealized holding losses on securities arising during period $ (1,901) $ (742) $ (1,159) Minimum pension liability (17,372) (6,645) (10,727) Less: Reclassification adjustments for net gains on securities realized in net income (26,247) (10,240) (16,007) -------------- --------------- ------------- Other comprehensive (loss) $ (45,520) $ (17,627) $ (27,893) ============== =============== ============= (22) Segment Information: -------------------- We operate in one reportable 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 our Frontier properties share similar economic characteristics, in that they provide the same products and services to similar customers using comparable technologies in all of the states in which we operate. The regulatory structure is generally similar. Differences in the regulatory regime of a particular state do not impact the economic characteristics or operating results of a particular property. Information for 2004 relates to our electric utility segment that was sold during 2004 and did not meet the criteria for classification as a discontinued operation. F-35 ($ in thousands) For the year ended December 31, 2004 ---------------- --- Total Frontier Electric Segments --------------- ----------------- ----------------- Revenue $ 2,012,643 $ 9,735 $ 2,022,378 Depreciation and Amortization 549,381 - 549,381 Management Succession and Strategic Alternatives Expenses 90,632 - 90,632 Operating Income (Loss) 463,435 (3,134) 460,301 Capital Expenditures 263,949 - 263,949 Assets 6,679,899 - 6,679,899 (23) Quarterly Financial Data (Unaudited): ------------------------------------- ($ in thousands, except per share amounts) -- First Second Third Fourth Quarter Quarter Quarter Quarter 2006 ---- --------- --------- --------- ---------- Revenue $506,861 $ 506,912 $ 507,198 $ 504,396 Operating income 157,338 169,458 160,720 156,974 Net income 50,483 101,702 128,459 63,911 Net income available for common shareholders per basic share $ 0.15 $ 0.32 $ 0.40 $ 0.20 Net income available for common shareholders per diluted share $ 0.15 $ 0.31 $ 0.40 $ 0.20 2005 ---- Revenue $502,334 $ 496,133 $ 501,211 $ 517,363 Operating income 144,481 142,281 136,920 165,286 Net income 42,634 44,584 38,376 76,781 Net income available for common shareholders per basic share $ 0.13 $ 0.13 $ 0.11 $ 0.23 Net income available for common shareholders per diluted share $ 0.13 $ 0.13 $ 0.11 $ 0.23 The quarterly net income per common share amounts are rounded to the nearest cent. Annual net income per common share may vary depending on the effect of such rounding. During the second quarter of 2006 we recorded a gain in investment income of $61.4 million resulting from the dissolution and liquidation of the Rural Telephone Bank. In the third quarter of 2006 we sold ELI (see Note 8). See Note 14 for a description of other miscellaneous transactions impacting our quarterly results. (24) Retirement Plans: ---------------- We sponsor a noncontributory defined benefit pension plan covering a significant number of our employees and other postretirement benefit plans that provide medical, dental, life insurance and other benefits for

covered retired employees and their beneficiaries and covered dependents. The benefits are based on years of service and final average pay or career average pay. Contributions are made in amounts sufficient to meet ERISA funding requirements while considering tax deductibility. Plan assets are invested in a diversified portfolio of equity and fixed-income securities and alternative investments. The accounting results for pension and postretirement benefit costs and obligations are dependent upon various actuarial assumptions applied in the determination of such amounts. These actuarial assumptions include the following: discount rates, expected long-term rate of return on plan assets, future compensation increases, employee turnover, healthcare cost trend rates, expected retirement age, optional form of benefit and mortality. We review these assumptions for changes annually with our independent actuaries. We consider our discount rate and expected long-term rate of return on plan assets to be our most critical assumptions. F-36 The discount rate is used to value, on a present value basis, our pension and postretirement benefit obligation as of the balance sheet date. The same rate is also used in the interest cost component of the pension and postretirement benefit cost determination for the following year. The measurement date used in the selection of our discount rate is the balance sheet date. Our discount rate assumption is determined annually with assistance from our actuaries based on the pattern of expected future benefit payments and the prevailing rates available on long-term, high quality corporate bonds that approximate the benefit obligation. In making this determination we consider, among other things, the yields on the Citigroup Pension Discount Curve and Bloomberg Finance and the changes in those rates from one period to the next. This rate can change from year-to-year based on market conditions that impact corporate bond yields. Our discount rate increased from 5.625% at year end 2005 to 6.00% at year end 2006. The expected long-term rate of return on plan assets is applied in the determination of periodic pension and postretirement benefit cost as a reduction in the computation of the expense. In developing the expected long-term rate of return assumption, we considered published surveys of expected market returns, 10 and 20 year actual returns of various major indices, and our own historical 5-year and 10-year investment returns. The expected long-term rate of return on plan assets is based on an asset allocation assumption of 35% to 55% in fixed income securities, 35% to 55% in equity securities and 5% to 15% in alternative investments. We review our asset allocation at least annually and make changes when considered appropriate. In 2006, we did not change our expected long-term rate of return from the 8.25% used in 2005. Our pension plan assets are valued at actual market value as of the measurement date. The measurement date used to determine pension and other postretirement benefit measures for the pension plan and the postretirement benefit plan is December 31. In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" (SFAS No. 158). We adopted SFAS No. 158 prospectively on December 31, 2006. SFAS No. 158 requires that we recognize all obligations related to defined benefit pensions and other postretirement benefits. This statement requires that we quantify the plans' funded status as an asset or a liability on our consolidated balance sheets. In accordance with SFAS No. 158, our 2005 accounting and related disclosures were not affected by the adoption of the new standard. The table below summarizes the incremental effects of SFAS No. 158 adoption on the individual line items in our consolidated balance sheet at December 31, 2006: Pre SFAS SFAS Post SFAS No. 158 No. 158 No. 158 ($ in thousands) Adoption Adjustment Adoption ---------------- -------- ---------- -------- Liabilities: Deferred income taxes $ 564,041 $ (49,911) $ 514,130 Other liabilities 199,100 133,545 332,645 Stockholder's Equity: Accumulated other comprehensive loss 1,735 (83,634) (81,899) SFAS No. 158 requires that we measure the plan's assets and obligations that determine our funded status as of the end of the fiscal year. We are also required to recognize as a component of Other Comprehensive Income "OCI" the changes in funded status that occurred during the year that are not recognized as part of net periodic benefit cost as explained in SFAS No. 87, "Employers' Accounting for Pensions," or SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." Based on the funded status of our defined benefit pension and postretirement benefit plans as of December 31, 2006, we reported a gain (net of tax) to our AOCI of $41.4 million, a decrease of $66.1 million to accrued pension obligations and an increase of $24.7 million to accumulated deferred income taxes. Our adoption of SFAS No. 158 on December 31, 2006, had no

impact on our earnings. The following tables present details about our pension plans. F-37 Pension Plan ----------- The following tables set forth the plan's projected benefit obligations and fair values of plan assets as of December 31, 2006 and 2005 and net periodic benefit cost for the years ended December 31, 2006, 2005 and 2004: ($ in thousands) 2006 2005 ---------------- ------------- -------------- Change in projected benefit obligation ------------------------------------- Projected benefit obligation at beginning of year $ 842,602 $ 799,458 Service cost 6,811 6,117 Interest cost 45,215 46,416 Actuarial (gain) loss (46,597) 48,750 Benefits paid (69,005) (58,139) Special termination benefits and other of (116) 1,693 - ------------- -------------- Projected benefit obligation at end of year $ 780,719 $ 842,602 ============= ============== Change in plan assets -------------------- Fair value of plan assets at beginning of year $ 762,225 $ 761,168 Actual return on plan assets 76,962 59,196 Employer contribution - - Benefits paid (69,005) (58,139) ------------- -------------- Fair value of plan assets at end of year $ 770,182 $ 762,225 ============= ============== (Accrued)/Prepaid benefit cost ------------------------------ Funded status $ (10,537) $ (80,377) ============= Unrecognized prior service cost (1,745) Unrecognized net actuarial loss 223,525 -------------- Prepaid benefit cost $ 141,403 ============== Amounts recognized in the consolidated balance sheet --- Other long-term liabilities $ (10,537) $ (58,250) ============= ============== Accumulated other comprehensive income $ 147,248 $ 199,653 ============= ============== Expected ($ in thousands) 2007 2006 2005 2004 ---------------- ------------- ------------- ------------- ------------- Components of net periodic benefit cost --------------------------------------- Service cost $ 6,811 $ 6,117 $ 5,748 Interest cost on projected benefit obligation 45,215 46,416 46,468 Expected return on plan assets (60,759) (60,371) (57,203) Amortization of prior service cost and unrecognized net obligation $ (255) (255) (244) (244) Amortization of unrecognized loss 6,585 11,871 9,882 8,806 ------------- ------------- -------------- Net periodic benefit cost 2,883 1,800 3,575 Special termination charge 1,809 - - ------------- ------------- -------------- Total periodic benefit cost $ 4,692 $ 1,800 $ 3,575 ============= ============= ============== F-38 The plan's weighted average asset allocations at December 31, 2006 and 2005 by asset category are as follows: 2006 2005 ---- ---- Asset category: --------------- Equity securities 53% 50% Debt securities 34% 34% Alternative investments 12% 13% Cash and other 1% 3% ----- ------ Total 100% 100% ===== ====== The plan's expected benefit payments by year are as follows: ($ in thousands) ---------------- Year Amount --------------- -------------- 2007 $ 52,441 2008 53,863 2009 57,319 2010 58,418 2011 59,892 2012 - 2016 320,383 -------------- Total $ 602,316 ============== Our required contribution to the plan in 2007 is $0. The accumulated benefit obligation for the plan was $762,085,000 and $820,475,000 at December 31, 2006 and 2005, respectively. Assumptions used in the computation of annual pension costs and valuation of the year-end obligations were as follows: 2006 2005 ------ ------ Discount rate - used at year end to value obligation 6.00% 5.625% Discount rate - used to compute annual cost 5.625% 6.00% Expected long-term rate of return on plan assets 8.25% 8.25% Rate of increase in compensation levels 4.00% 4.00% Postretirement Benefits Other Than Pensions - "OPEB" --- The following table sets forth the plan's benefit obligations, fair values of plan assets and the postretirement benefit liability recognized on our balance sheets at December 31, 2006 and 2005 and net periodic postretirement benefit costs for the years ended December 31, 2006, 2005 and 2004. In 2005, we approved changes to certain retiree medical plans. The plan changes (reflected as amendments in the table below) and the related impact are included in the accumulated postretirement benefit obligation (APBO) as of December 31, 2005. The plan changes resulted in a reduction in the APBO of $59,798,000 which will be amortized as a reduction of retiree medical expense over the average remaining service life. Assumptions used in the computation of annual OPEB costs and valuation of the year-end OPEB obligations were as follows: 2006 2005 ------ ------ Discount rate - used at year end to value obligation 6.00% 5.625% Discount rate - used to compute annual cost 5.625% 6.00% Expected long-term rate of return on plan assets 8.25% 8.25% F-39 ($ in thousands) 2006 2005 ---------------- ------------- ------------- Change in benefit obligation --------------------------- Benefit obligation at beginning of year $ 160,922 $ 217,380 Service cost 664 1,046 Interest cost 8,974 12,055 Plan participants' contributions 1,558 3,461 Actuarial loss 1,778 3,770

Amendments - (59,798) Benefits paid (13,965) (16,992) ------------- --------------
Benefit obligation at end of year $ 159,931 $ 160,922 =============
============== Change in plan assets --------------------- Fair value of plan assets
at beginning of year $ 11,424 $ 15,126 Actual return on plan assets 445 397 Benefits
paid (12,407) (13,530) Employer contribution 12,407 9,431 ------------- --------------
Fair value of plan assets at end of year $ 11,869 $ 11,424 =============
============== Accrued benefit cost -------------------- Funded status $(148,062)
$(149,498) ============= Unrecognized prior service cost (61,161) Unrecognized
loss 42,325 -------------- Accrued benefit cost $(168,334) ==============
Amounts recognized in the consolidated balance sheet
-- Current liabilities $ (7,238) $ -
============= ============== Other long-term liabilities $(140,824)
$(168,334) ============= ============== Accumulated other comprehensive
income $ (13,703) $ - ============= ============== Expected ($ in
thousands) 2007 2006 2005 2004 --------------- ------------- ------------- -------------
------------- Components of net periodic postretirement benefit cost
--- Service cost $ 664 $ 1,046 $ 1,128
Interest cost on projected benefit obligation 8,974 12,055 12,698 Return on plan
assets (889) (1,248) (2,268) Amortization of prior service cost and transition
obligation $ (7,586) (7,589) (1,255) (204) Amortization of unrecognized loss 4,064
4,678 6,615 5,238 ------------- ------------- -------------- Net periodic postretirement
benefit cost $ 5,838 $ 17,213 $ 16,592 ============= =============
============== F-40 The plan's weighted average asset allocations at December
31, 2006 and 2005 by asset category are as follows: 2006 2005 ---- ---- Asset
category: --------------- Equity securities 0% 0% Debt securities 100% 100% Cash and
other 0% 0% ------ ------ Total 100% 100% ====== ====== The plan's expected
benefit payments by year are as follows: ($ in thousands) ---------------- Gross
Medicare D Year Benefits Subsidy Total --------------- -------------- -------------
------------- 2007 $ 10,069 $ 346 $ 9,723 2008 10,386 395 9,991 2009 10,757 455
10,302 2010 11,129 510 10,619 2011 11,648 - 11,648 2012 - 2016 59,857 - 59,857
-------------- ------------- -------------- Total $ 113,846 $ 1,706 $ 112,140
============== ============= ============== Our expected contribution
to the plan in 2007 is $9,723,000. For purposes of measuring year-end benefit
obligations, we used, depending on medical plan coverage for different retiree groups,
a 9.0% annual rate of increase in the per-capita cost of covered medical benefits,
gradually decreasing to 5% in the year 2015 and remaining at that level thereafter.
The effect of a 1% increase in the assumed medical cost trend rates for each future
year on the aggregate of the service and interest cost components of the total
postretirement benefit cost would be $620,000 and the effect on the accumulated
postretirement benefit obligation for health benefits would be $8,816,000. The effect
of a 1% decrease in the assumed medical cost trend rates for each future year on the
aggregate of the service and interest cost components of the total postretirement
benefit cost would be $(517,000) and the effect on the accumulated postretirement
benefit obligation for health benefits would be $(7,844,000). In December 2003, the
Medicare Prescription Drug Improvement and Modernization Act of 2003 (the Act)
became law. The Act introduces a prescription drug benefit under Medicare. It
includes a federal subsidy to sponsors of retiree health care benefit plans that provide
a benefit that is at least actuarially equivalent to the Medicare Part D benefit. The
amount of the federal subsidy is based on 28% of an individual beneficiary's annual
eligible prescription drug costs ranging between $250 and $5,000. We have
determined that the Company-sponsored postretirement healthcare plans that provide
prescription drug benefits are actuarially equivalent to the Medicare Prescription Drug
benefit. The impact of the federal subsidy has been incorporated into the calculation.
The amounts in accumulated other comprehensive income that have not yet been
recognized as components of net periodic benefit cost at December 31, 2006 are as
follows: ($ in thousands) Pension Plan OPEB ---------------- ------------ ------ Net
actuarial loss $ 148,854 $ 39,869 Prior service cost (1,606) (53,572) --------- ----------
Total $ 147,248 $ (13,703) ========= ========== F-41 The amounts recognized
as a component of accumulated comprehensive income for the year ended December
31, 2006 are as follows: ($ in thousands) Pension Plan OPEB ---------------- ------------
----------- Net actuarial loss recognized during year $ (11,871) $ (4,678) Prior service
cost recognized during year 255 7,589 Net actuarial loss (gain) occurring during year

(62,800) 2,222 Prior service cost (credit) occurring during year (116) - Other adjustments 22,128 (18,836) ------------ ----------- Net amount recognized in comprehensive income for the year $ (52,404) $ (13,703) ============ =========== 401(k) Savings Plans ------------------- We sponsor an employee retirement savings plan under section 401(k) of the Internal Revenue Code. The plan covers substantially all full-time employees. Under the plan, we provide matching and certain profit-sharing contributions. Employer contributions were $4,705,000, $6,665,000 and $7,931,000 for 2006, 2005 and 2004, respectively. (25) Commitments and Contingencies: ----------------------------- 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. 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 believed that we would be responsible for only a portion of the cost to clean up and the final resolution of this matter would not be material to the operating results nor the financial condition of the Company. Subsequent to the June 27, 2006 judgment, we began settlement discussions with the City, with participation from the State of Maine. In January 2007, we reached an agreement in principle to settle the matter for a payment by us of $7,625,000. The Bangor City Council has approved the settlement terms, and a settlement agreement has been executed by the City and Citizens. Completion of settlement remains contingent upon entry of a Consent Decree with the State that is reasonably acceptable to us. We are in negotiations with the State over the terms of the Consent Decree. If the settlement of this matter does not become effective, 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. F-42 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 using or have used any of the processes that are protected by its patents but received no correspondence in this regard from late 2004 through January 2007. In January 2007, we received a letter from counsel to Katz Technology asking to meet with us to discuss Katz Technology's

continuing offer of a license under Katz Technology's patents. We are continuing to investigate whether we are utilizing Katz Technology's patented technology, and will discuss Katz Technology's license offer with them, as and when appropriate. 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 $1,000,000,000. In August 2004, we notified Citibank by letter that we believe its claims for indemnification are invalid and are not supported by applicable law. We have received no further communications from Citibank since our August 2004 letter. We are party to other legal proceedings arising in the normal course of our business. The outcome of individual matters is not predictable. However, we believe that the ultimate resolution of all such matters, after considering insurance coverage, will not have a material adverse effect on our financial position, results of operations, or our cash flows. Although we from time to time make short-term purchasing commitments to vendors with respect to these expenditures, we generally do not enter into firm, written contracts for such activities. We conduct certain of our operations in leased premises and also lease certain equipment and other assets pursuant to operating leases. The lease arrangements have terms ranging from 1 to 99 years and several contain rent escalation clauses providing for increases in monthly rent at specific intervals. When rent escalation clauses exist, we record total expected rent payments on a straight-line basis over the lease term. Certain leases also have renewal options. Renewal options that are reasonably assured are included in determining the lease term. Future minimum rental commitments for all long-term noncancelable operating leases and future minimum capital lease payments for continuing operations as of December 31, 2006 are as follows: ($ in thousands) ---------------- Operating Leases ---------- Year ending December 31: 2007 $ 15,794 2008 9,817 2009 9,693 2010 8,593 2011 7,311 Thereafter 18,185 --------- Total minimum lease payments $ 69,393 ========= F-43 Total rental expense included in our results of operations for the years ended December 31, 2006, 2005 and 2004 was $16,281,000, $16,859,000 and $17,410,000, respectively. We are a party to contracts with several unrelated long distance carriers. The contracts provide fees based on traffic they carry for us subject to minimum monthly fees. At December 31, 2006, the estimated future payments for obligations under our noncancelable long distance contracts and service agreements are as follows: ($ in thousands) ---------------- Year --------------- --------------- 2007 $ 26,449 2008 18,899 2009 16,610 2010 7,382 2011 165 thereafter 660 --------------- Total $ 70,165 =============== We sold all of our 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 No. 45 requires that we disclose "the maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee." Paragraph 13 also states that we must make such disclosure "... even if the likelihood of the guarantor's having to make any payments under the guarantee is remote..." As

noted above, our obligation only arises as a result of default by another VJO member, such as upon bankruptcy. Therefore, to satisfy the "maximum potential amount" disclosure requirement we must assume that all members of the VJO simultaneously default, a highly unlikely scenario given that the two members of the VJO that have the largest potential payment obligations are publicly traded with credit ratings equal to or superior to ours, and that all VJO members are regulated utility providers with regulated cost recovery. Regardless, despite the remote chance that such an event could occur, or that the State of Vermont could or would allow such an event, assuming that all the members of the VJO defaulted on January 1, 2008 and remained in default for the duration of the contract (another 8 years), we estimate that our undiscounted purchase obligation for 2008 through 2015 would be approximately $1.1 billion. In such a scenario the Company would then own the power and could seek to recover its costs. We would do this by seeking to recover our costs from the defaulting members and/or reselling the power to other utility providers or the northeast power grid. There is an active market for the sale of power. We could potentially lose money if we were unable to sell the power at cost. We caution that we cannot predict with any degree of certainty any potential outcome. At December 31, 2006, we have outstanding performance letters of credit as follows: ($ in thousands) ---------------- Cellco (Verizon Wireless) $ 375 CNA 19,404 State of New York 2,993 ELI projects 50 -------- Total $ 22,822 ======== F-44 CNA serves as our agent with respect to general liability claims (auto, workers compensation and other insured perils of the Company). As our agent, they administer all claims and make payments for claims on our behalf. We reimburse CNA for such services upon presentation of their invoice. To serve as our agent and make payments on our behalf, CNA requires that we establish a letter of credit in their favor. CNA could potentially draw against this letter of credit if we failed to reimburse CNA in accordance with the terms of our agreement. The value of the letter of credit is reviewed annually and adjusted based on claims history. None of the above letters of credit restrict our cash balances. F-45