Z TEL TECHNOLOGIES INC
Form 10-K
March 30, 2004

**Table of Contents**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-K**

(MARK ONE)
**[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**
**FOR THE YEAR ENDED DECEMBER 31, 2003**

OR

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM TO**

*COMMISSION FILE NUMBER: 000-28467*

**Z-TEL TECHNOLOGIES, INC.**

(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| DELAWARE | 59-3501119 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |

**601 SOUTH HARBOUR ISLAND BOULEVARD, SUITE 220**
**TAMPA, FLORIDA 33602**
(813) 273-6261
(Address, including zip code, and telephone number including area code, of Registrant s principal executive offices)

**SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE**

**SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: COMMON STOCK, PAR VALUE $.01 PER SHARE, PREFERRED STOCK PURCHASE RIGHTS**

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 [ ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12B-2 of the Exchange Act)

Yes [ ] No [X]

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 [ ].

The aggregate market value of the Registrant s Common Stock held by non-affiliates of the Registrant on March 29, 2004 (assuming solely for these purposes that only directors, executive officers and beneficial owners of greater than 10% of the Registrant s Common Stock are affiliates), based on the closing price of the Common Stock on the Nasdaq SmallCap Market as of such date, was approximately $60,964,111.

The number of shares of the Registrant s Common Stock outstanding as of March 30, 2004 was approximately 36,168,028.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant s proxy statement relating to its 2004 Annual Meeting of Stockholders, to be filed subsequently, are incorporated by reference into Part III of this Report.

1

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TABLE OF CONTENTS

**ITEM 1. BUSINESS**

**GENERAL**

Z-Tel Technologies, Inc. is a communications service provider. We provide innovative and cost effective telecommunications services to consumers, business and other communications companies by integrating our own enhanced communications systems and advanced operational support systems with access to communication networks. Our systems have the capability to integrate with wireline, wireless, cable, Internet and other communications transport networks. Our current generation of services relies primarily on access to local and long distance telephone networks. A recent court ruling has created legal uncertainty regarding our access to local telephone networks. See sections of this report entitled Government Regulation and Risks Relating to Our Financial Condition and Our Business. We plan to launch a new generation of services using voice over Internet protocol ( VoIP ) in 2004.

We provide services on both a retail and wholesale basis. Our principal retail services are Z-LineHOME®, Z-LineBUSINESS® and Touch 1 Long Distance. Z-LineHOME and Z-LineBUSINESS are residential and business versions, respectively, of our flagship offering, the Z-Line®. The Z-Line is local telephone service, typically bundled with long distance and enhanced features, including a suite of our proprietary Internet-accessible and voice-activated functions. The enhanced features include voicemail, Find Me call forwarding and our recently introduced Personal Voice Assistant , or PVA, which utilizes voice-recognition technology so that users can access secure, online address books from any phone using simple voice commands in order to send voice emails, find contact information and dial numbers, among other things. Touch 1 long distance is a residential long distance telephone service.

We have approximately 190,000 Z-LineHOME® lines and 32,000 Z-LineBUSINESS® lines under management and approximately 65,000 Touch 1 Long Distance customers. We gained nearly all of the Touch 1 Long Distance customers with our acquisition of Touch 1 Communications, Inc. in April 2000.

We plan to launch VoIP-based services in 2004, focusing initially on the small-to-medium business market and multiple dwelling units such as condominiums, apartment buildings and hotels in Georgia and Florida. Our VoIP initiative is in the testing phase. At the wholesale level, we provide telephone services, enhanced communications services and operational support services to other telephone companies for their use in providing telephone services and enhanced communications services to their own end user customers. Our principal wholesale customer is Sprint Communications Company ( Sprint ), which became a wholesale customer in February 2003. An agreement for wholesale services with MCIWORLDCOM ( MCI ) was terminated in October 2003. We have approximately 330,000 end user lines under management in connection with our wholesale relationships.

Table of Contents

We have invested heavily in our enhanced communications platform and our operational support systems. Our enhanced communications platform enables us to offer distinctive Web integrated and voice activated features, including PVA. Our advanced operational support systems are functionally integrated to support the entire customer life cycle including price quotation, order entry and processing, ILEC interaction, customer care, billing and subscriber management. We believe our operational systems are scalable, both vertically and horizontally, and give us reliable, flexible, low-cost operational capabilities.

Our current generation of local telephone services, which produces approximately 95% of our revenue, relies on access to local telephone networks. Our access to these networks is based upon the Telecommunications Act of 1996 (the Telecommunications Act ) which imposes a variety of duties upon the traditional local telephone companies ( incumbent local exchange carriers or ILECs ), including the duty to provide competitive local exchange companies ( CLECs ), like us, with access to the individual components of their networks. The Federal Communications Commission ("FCC") has issued various rules regarding access to these components, including access to transport and switching. A recent court ruling, however, has created considerable legal uncertainty regarding this access. In *United States Telecom Ass n v. FCC*, Nos. 00-1012, 00-1015, 03-1310 *et al.* (D.C. Cir. March 2, 2004) ( *USTA II* ), the D.C. Circuit Court ordered that the FCC s unbundled transport and switching rules be vacated after sixty days or upon denial of a petition for rehearing, whichever occurs later. Although a majority of the FCC has indicated that it will support an appeal and we believe there are substantial arguments in favor of such an appeal, this ruling and the uncertainty it has created could have material, adverse effects upon us and our operations, including, among other matters, our ability to obtain financing, our relationships with major customers and prospective customers, our relationships with major marketing partners and prospective marketing partners, the pricing, credit and other terms we receive from the ILECs, long distance companies and other vendors and an increase in legal expenditures. See sections of this report entitled Government Regulation and Risks Relating to Our Financial Condition and Our Business. Our planned 2004 launch of a new generation of VoIP services could, over time, mitigate our reliance on access to ILEC networks.

## SEGMENT FINANCIAL INFORMATION

We utilize two segments for internal reporting purposes: retail services and wholesale services. Financial information relating to our retail services segment and our wholesale services segment (including information relating to the revenue contributed by our services) is set forth in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and footnote 22 Segment Reporting in the Notes to the Consolidated Financial Statements.

## INDUSTRY BACKGROUND

The Telecommunications Act of 1996 (the Telecommunications Act ) was enacted principally to foster competition in the local telecommunications markets. The Telecommunications Act imposes a variety of duties upon the ILECs, including the duty to provide other communications companies, like us, with access to the individual components of their networks, called network elements, on an unbundled basis at any feasible point and at rates and on terms and conditions that are just, reasonable and nondiscriminatory. A network element is a facility or piece of equipment of the ILEC s network or the features, functions or capabilities such facility or equipment provides. Pursuant to the Telecommunications Act, the Federal Communications Commission ( FCC ) has mandated that incumbent local exchange carriers provide access to a set of unbundled network elements including, among other elements, local loops (i.e. the wires that reach from the ILEC central office to the end user s premises), switching, transport and signaling. This set of elements is referred to as the unbundled network element platform or UNE-P. Moreover, the FCC has mandated that ILECs must provide the unbundled network element platform at rates based on a forward-looking, total long-run incremental cost methodology. A recent court ruling has overturned, in part, FCC decisions relating to UNE-P. This ruling could have immediate, material, adverse effects upon our business. See sections entitled

Government Regulation and Risks Relating to Our Financial Condition and Our Business.

The Telecommunications Act also establishes procedures by which the regional Bell operating companies ( Bell operating companies ) are allowed to handle in-region long distance calls, that is, calls that originate from within their telephone service areas and terminate outside their service areas. The 1984 court order that divided AT&T prohibited Bell operating companies from providing in-region long distance telephone service. Under the Telecommunications Act, Bell operating companies can provide such in-region service if they demonstrate to the FCC and state regulatory agencies that they have complied with a 14-point regulatory checklist, including offering interconnection to other communications companies, like us, and providing those companies access to their unbundled network elements on terms approved by a state public service commission. Bell operating companies have received authority to provide in-region long distance services in all 47 applicable states. However, the Section 271 checklist is a continuing obligation pursuant to section 271(d)(6) of the Telecommunications Act. See section of this report entitled Government Regulation.

**RETAIL SERVICES**

We provide telephone services at both the retail and wholesale level. At the retail level our principal services are Z-LineHOME, Z-LineBUSINESS and Touch 1 Long Distance. We plan to launch a new generation of VoIP-based services in 2004.

Table of Contents

**Z-LineHOME®**

Z-LineHOME is local residential telephone service bundled with long distance (1+) telephone service, calling card services and enhanced features, including our own proprietary, Internet-accessible voicemail, Find Me, Notify Me and voice-activated services, as well as caller identification, call forwarding, three-way calling, call waiting and speed dialing, all for a single flat monthly price. We offer various plans, including our Unlimited Plan which includes unlimited, nationwide, direct-dialed long distance calling toll-free and lower priced plans that include a limited number of long distance minutes at no additional charge. Bell operating company customers switching to Z-LineHOME keep their existing phone numbers. We currently offer Z-LineHOME in every state except Alaska, in areas served by Bell operating companies and selected areas served by Sprint or formerly served by GTE.

Z-LineHOME includes unique Z-Line features, all of which can be accessed and manipulated by telephone or Internet. Our proprietary voicemail enables Z-LineHOME subscribers to retrieve and listen to their voice-mail messages via telephone or the Internet. Our voicemail system also enables users to forward voicemails via e-mail, as attachments. Our Find-Me feature forwards an incoming call to as many as three additional numbers. Our Notify Me feature notifies the subscriber via e-mail, pager or ICQ Internet Chat (instant messaging) when a new voice mail message arrives. Both Find Me and Notify Me are accessible via the Internet so that users may easily enable, disable or otherwise alter the functions. Personal Voice Assistant or PVA allows users to store contacts in a virtual address book and then access and utilize that information through voice commands from any telephone. Users say call and the contact s name, call John Doe, for example, and PVA connects the call. PVA users can also send voice e-mails. Users record a message via telephone and instruct PVA to deliver the message to a contact. PVA then attaches the voice message to an e-mail and sends the e-mail to the contact.

We market and sell Z-LineHOME primarily through joint marketing efforts with entities that have access to large numbers of consumers, independent sale contractors (including multi-level marketing companies) and referral programs. We also use, but have reduced our reliance upon, direct mail and traditional advertising media such as billboards, radio and television.

**Z-LineBUSINESS®**

Z-LineBUSINESS is our complementary service to Z-LineHOME targeted to small and medium sized businesses (typically having four or fewer lines) and businesses having multiple units. Z-LineBUSINESS, like Z-LineHOME, is local telephone service bundled with long distance (1+) telephone service, calling card services and enhanced features, including our proprietary features. Because we offer service in nearly every state, Z-LineBUSINESS is particularly valuable to firms having multiple locations in various states. With us, they deal with only one telephone company. We began offering Z-LineBUSINESS in 2002. We offer Z-LineBUSINESS in every state but Alaska, in areas served by a Bell operating company or formerly served by GTE. Current customers include Darden Restaurants, Compass, Foot Locker, Metromedia Restaurant Group and Rand McNally Stores.

We market and sell Z-LineBUSINESS primarily through our own in-house sales personnel and independent sale contractors.

**Touch 1 Long Distance**

Touch 1 Long Distance is a usage-based service that allows customers to use us as their primary long distance calling provider to complete their residential long distance (1+) calls. Touch 1 Long Distance is available nationwide. We do not actively market the service. We acquired Touch 1 Communications, Inc. ("Touch 1") in April 2000.

**VoIP Services**

We plan to launch an offering of broadband voice and data services in 2004. We expect to focus initially on the small-to-medium business market and multiple dwelling units, such as condominiums, apartment buildings and hotels, in Georgia and Florida. Our VoIP services will be integrated with our enhanced communications services platform so that in addition to increased bandwidth and service flexibility, our customers will enjoy features such as PVA, our voice-activated virtual address book. We expect to utilize Cisco technology and services in providing these services.

**Billing and Collection**

We have three primary methods for billing and collecting from our retail customers. For our Z-LineHOME customers, we can (1) direct bill by mail and receive payment through a check or money order by mail; (2) charge a credit card account or (3) set up an automatic withdrawal from a checking account. Currently, we bill the majority of our customers by mail and receive payment through checks delivered by mail.

**WHOLESALE SERVICES**

At the wholesale level, we offer a comprehensive package of communications and advanced support services to other communications companies for their use in providing services to their own retail customers. Among the wholesale services we offer are local exchange telephone services, long distance telephone services, our proprietary enhanced features, supplemental features we acquire from incumbent local exchange carriers, ordering, provisioning (i.e. the process by which a telephone company is established as the end user s primary telephone company), inbound sales, fulfillment, billing, collections and customer care. Our enhanced communications platform has the capability to integrate with most communications transport networks, including wireless, cable, and Internet networks. We intend to pursue wholesale relationships with, among others, wireless telephone companies, Internet service providers, cable television operators, electrical utilities and others having access to large consumer bases. To provide telephone services these entities must be properly licensed by regulatory authorities of the states in which they operate.

On February 4, 2003, we signed a non-exclusive, wholesale services agreement with the Sprint Communications Company L.P. ( Sprint ). The agreement gives Sprint access to our telephone exchange services and our Web-integrated, enhanced communications platform and operational support systems in connection with Sprint s local residential telephone service. Sprint is our primary wholesale services customer.

On March 20, 2002, we entered into a four-year contract with MCI WORLDCOM Communications, Inc. ( MCI ) whereby we agreed to provide local exchange services, enhanced features and operational and support services and licenses to use certain of our proprietary technology, all for MCI s use in providing telecommunications services to residential and small business customers. MCI filed for bankruptcy protection on July 21, 2002. On November 1, 2002, we significantly amended the terms of our agreement to alter the fee structure and to eliminate certain exclusivity provisions. MCI terminated the agreement effective October 15, 2003.

**OPERATIONS SUPPORT SYSTEMS**

We have invested heavily in our operations systems and support platform. The platform integrates ordering, provisioning, customer care and billing functionality throughout the customer lifecycle and consequently gives us (and our wholesale customers) reliable, flexible, low-cost operational capabilities. We believe our operational systems are scalable, both vertically and horizontally. They have the capability to integrate with wireline, wireless, cable, Internet and other communications transport networks

Our current generation of telephone services requires access to ILEC networks. To facilitate interaction with the ILECs, we have established, with outside integration and consulting assistance, electronic gateways, software and a standard internal provisioning interface. Our systems can interact with the ordering systems of multiple incumbent local exchange carriers. They reduce the number of steps required to provision a customer and consequently reduces costs and increases accuracy. Provisioning is the process by which we (or our wholesale customers) are established as the end user's primary local exchange and long distance telephone service provider. Our systems also support mediation, network administration and revenue assurance.

**BUSINESS STRATEGY**

Our basic business strategy is to

Increase lines under management and leverage our existing facilities and infrastructure by establishing wholesale and joint marketing relationships with organizations having access to large consumer bases, particularly those having the capability to bundle communication services

Reduce bad debt and customer churn by focusing our retail marketing efforts on business customers and select groups of qualified consumers

Initiate VoIP-based services for consumers and businesses.

Material changes in the regulatory environment in which we operate, particularly in light of a recent court ruling overturning, in part, FCC rules, could cause us to dramatically alter our business strategy. See sections entitled Government Regulation and Risks Relating to Our Financial Condition and Our Business.

## GOVERNMENT REGULATION

### Overview

Some of our services are regulated and some are not. In providing enhanced features services such as voice mail, Find-Me notification and directory services, we operate as an unregulated provider of information services, as that term is defined in the Communications Act of 1934 (the Communications Act ), as amended by the Telecommunications Act of 1996 (the Telecommunications Act ), and as an enhanced service provider, as that term is defined in the FCC rules. These operations currently are not regulated by the FCC or the states in which we operate. In providing Z-LineHOME and our long distance services, we are regulated as a common carrier at the state and federal level and are subject to additional rules and policies not applicable to providers of information services alone. We are certificated as a competitive local exchange carrier in

**Table of Contents**

49 states (Alaska excluded) and the District of Columbia. Z-Tel is certificated as a long-distance reseller in all fifty states and the District of Columbia.

The local and long distance telecommunications services we provide are regulated by federal, state, and, to some extent, local government authorities. The FCC has jurisdiction over all telecommunications common carriers to the extent they provide interstate or international communications services. Each state regulatory commission has jurisdiction over the same carriers with respect to intrastate communications services. The extent of federal or state regulation of information services depends upon the nature of the service offered. Local governments sometimes seek to impose franchise requirements on telecommunications carriers and regulate construction activities involving public rights-of-way. Changes to the regulations imposed by any of these regulators could have a material adverse effect on our business, operating results and financial condition.

In recent years, the regulation of the telecommunications industry has been in a state of flux as the United States Congress and various state legislatures have passed laws seeking to foster greater competition in telecommunications markets. The FCC and state utility commissions have adopted many new rules to implement this legislation and encourage competition. These changes, which are still incomplete, have created new opportunities and challenges for us and our competitors. The following summary of regulatory developments and legislation is intended to describe the most important, but not all, present and proposed federal, state and local regulations and legislation affecting the telecommunications industry. Some of these and other existing federal and state regulations are the subject of judicial proceedings and legislative and administrative proposals that could change, in varying degrees, the manner in which our industry operates. We cannot predict the outcome of any of these proceedings or their impact on the telecommunications industry at this time. Some of these future legislative, regulatory or judicial changes may have a material adverse impact on our business.

While Z-Tel s regulatory environment continues to be dynamic and complex, there are two overriding issues that substantially drive our business: (1) our ability to access the local networks of incumbent local telephone companies (like Verizon, SBC, BellSouth and Qwest) and (2) the price we pay for that access. Both of those issues network access and pricing are currently subject to significant legal uncertainty.

With regard to network access rules, as discussed more fully below, access to ILEC unbundled network elements pursuant to Section 251 of the Telecommunications Act is currently subject to considerable legal uncertainty. In particular, our access to unbundled analog switching, a key component of the Unbundled Network Element Platform combination of elements, or UNE-P, is the subject of litigation by our Bell company competitors and other incumbent local exchange carriers. We are dependent upon use of UNE-P for approximately 95% of our revenue.

In 2003, in the *Triennial Review Order,* the Federal Communications Commission ( FCC ) ruled that entrants like Z-Tel would be able to purchase analog switching and dedicated transport on an unbundled basis, subject to state-by-state review of whether such unbundling was needed in their states. While those state-by-state proceedings were taking place, on March 2, 2004, the D.C. Circuit Court of Appeals overturned the FCC s decision as an improper delegation of authority to state public utility commissions. *See* Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd 16978 (2003) ( *Triennial Review Order* ), *rev d in part and remanded, United States Telecom Ass n v. FCC*, Nos. 00-1012, 00-1015, 03-1310 *et al.* (D.C. Cir. March 2, 2004) ( *USTA II* ). The D.C. Circuit ordered that the unbundled switching and transport rules be vacated the later of sixty days or upon denial of a petition for rehearing, whichever is later. A majority of the FCC has indicated it will support an appeal of this decision. Z-Tel is weighing its legal options with regard to this opinion, as are other competitive carriers. If the *USTA II* decision is not stayed or reversed, it could have immediate, significant, adverse and material impact upon our business, and ILECs might utilize the reversal of the unbundling rules to deny us access to their local networks. We depend upon such access to provide our services to our customers. We believe that in the event the rules are vacated without any replacement by either the FCC or the state commissions, we have interconnection agreements with our principal incumbent local telephone company suppliers (including Verizon, SBC, BellSouth and Qwest) that will permit us to continue to obtain access to local network elements during any intervening time period. However, it is possible that any or all of those incumbent local telephone company suppliers will refuse to abide by the terms of those agreements or terminate those agreements. Z-Tel is currently evaluating all of its legal options to ensure that we can continue to meet the needs of our existing and future customers. See section entitled Risks Relating to Our Financial Condition and Our Business.

With regard to pricing, states and the FCC are currently re-evaluating the pricing of network elements. As a result, it is possible that prices in some states could increase or lower rates from existing levels. Currently, the incumbent local exchange carriers Verizon, BellSouth, SBC and Qwest have rate cases pending before state regulatory commissions in at least one state in each of their respective territories. In particular, ongoing rate cases in Illinois, Ohio and Michigan could significantly raise the existing rates for some network elements and network element combinations. Our intent is to be an active participant in many of these rate cases and any others that might be critical to our operations. We anticipate joining other competitive service providers in arguing that existing rates and rates proposed by the incumbents are overstated and do not reflect the true total element long run incremental costing principles required by the FCC and the Telecommunications Act. The FCC, in Docket No. 03-173 is currently reevaluating its prescribed methodology for calculating unbundled network element rates. In the 2002 *Verizon v. FCC* decision, the U.S. Supreme Court affirmed the FCC s current pricing methodology, called Total Element Long Run Incremental Cost, or

Table of Contents

TELRIC. The current FCC rulemaking proposes to modify the TELRIC methodology by mandating that states set prices based upon the forward-looking costs of operating the existing network architecture of incumbent local telephone company networks. In many instances, modifying the TELRIC methodology in this way could increase the rates we pay for certain elements and result in lower rates for other elements. We believe that the FCC s proposals to modify TELRIC are inconsistent with the Supreme Court s decision in the *Verizon* case, meaning that new FCC TELRIC rules may be subject to considerable litigation if they are adopted.

While the prevailing productivity trends within the industry would predict the adoption of lower rates in association with the provision of unbundled network elements and network element combinations, we cannot predict the outcome of any pending or potential rate case or judicial proceeding. Increases or decreases in rate levels charged by incumbent local exchange carriers as a result of regulatory and/or judicial review through rate case, court case or arbitration proceedings could significantly impact our business plans.

**FEDERAL REGULATION**

**FCC Policy on Enhanced, Information Services and Internet Protocol-Enabled Services (such as Voice over Internet Protocol)**

On March 10, 2004, the FCC released a Notice of Proposed Rulemaking that seeks to establish a comprehensive regulatory framework for Internet Protocol-Enabled Services, or IP-Enabled Services. IP-Enabled Services include Voice over Internet Protocol services and other services that Z-Tel intends to deploy or may in the future deploy. The FCC proposed that IP-Enabled Services be subject to limited regulation and that inconsistent state and local regulation would be preempted. Under the FCC s proposal, the regulation that survives would be tied to the particular functionality offered by the service provider. For example, the application of emergency 9-1-1 services may be different for dial tone-like services than for the voice capabilities of interactive computer games.

The FCC IP-Enabled Services proceeding builds upon several decades of precedent in which the FCC has largely sought to wall-off from regulation certain enhanced or information services. In 1980, the FCC created a distinction between basic telecommunications services, which it regulates as common carrier services, and enhanced services, which remain unregulated. The FCC exempted enhanced service providers from federal regulations governing common carriers, including the obligation to pay access charges for the origination or termination of calls on carrier networks and the obligation to contribute to the universal service fund. The Telecommunications Act of 1996 established a similar distinction between telecommunications services and information services.

The distinction between information services and common carrier services is important in many respects. Federal (tariffs), state (certification requirements) and even local regulation (franchise or rights of way fees) apply to common carrier services but not necessarily all information services. Under FCC rules, interstate common carriers must contribute a percentage of revenue to federal universal service support systems; information service providers do not make such a contribution. At the same time, common carriers are granted certain rights that information service providers do not have for example, only common carriers have the ability to colocate equipment and purchase unbundled network elements from incumbent local telephone companies pursuant to Section 251 of the Telecommunications Act. Interexchange common carriers (e.g., long-distance providers) generally have to pay access charges to local exchange companies for long-distance calls that originate or terminate on a local exchange carrier s local network. Information service providers (such as an Internet service provider) do not pay these access charges when their customers utilize local exchange carrier networks to utilize the information service provider s service. As discussed above, since Z-Tel offers both common carrier and information services to its customers, these distinctions have an important impact upon our business.

Changing technology and changing market conditions, however, sometimes make it difficult to discern the boundary between unregulated and regulated services. In particular, the ability to place and route voice communications over information service provider networks (e.g. the Internet) has called into question the FCC s common carrier/information service provider distinction. In 1998, the FCC outlined in a *Report to Congress* its belief that voice over Internet services should be classified and regulated, if at all, on a case-by-case basis. Since that report, several companies have filed petitions seeking declarations from the FCC as to the regulatory status of VoIP services. In February 2004, the FCC ruled that Pulver.com s Free World Dialup service was an information service and not a regulated common carrier service because Free World Dialup did not offer its users the ability to transmit calls for a fee. Currently pending before the FCC is a petition by AT&T requesting that certain of its long-distance services that utilize IP technology be regulated as an information service, and therefore not be subject to pay access charges to local exchange carriers. Also pending before the FCC is a petition by Level(3) Communications that seeks forbearance of certain access charge rules that have certain of Level(3) s IP-enabled services pay local termination rates rather than interstate access charges.

In general, information services are value-added services that use regulated transmission facilities only as part of a service package that also includes network or computer software to change or enhance the information transmitted. We believe that most of the enhanced features we provide, including voice mail, Find-Me notification, and directory services, are information services under the FCC s definition. Because the regulatory boundaries in this area are somewhat unclear and subject to dispute, however, the FCC could seek to characterize some of our information services as telecommunications services or subject them to certain types

Table of Contents

of regulation applicable to common carrier telecommunications services. If that happens, those services would become subject to FCC regulation, although the impact of that reclassification is difficult to predict.

In addition, certain of Z-Tel s planned VoIP-based services could be classified as information services in a way that could potentially limit our ability to access the local networks of incumbent local telephone companies. As described above, only common carriers have rights to colocate or purchase unbundled network elements from incumbent local telephone companies. It is unclear how or when the FCC IP-Enabled Services proceeding will conclude.

On February 14, 2002, the FCC adopted a Notice of Proposed Rulemaking in CC Docket No. 02-42 that proposed to classify ILEC wireline broadband Internet access services as information services and regulate the provision of such services pursuant to Title I of the Communications Act of 1934. In addition, the FCC sought comment on its *Computer II/Computer III* rules, which govern access to incumbent networks by third parties to provide information services. The proposed rules could, if adopted without adequate assurances for competitive access, limit the ability of new entrants to access and utilize the networks of incumbent local exchange carriers to provide advanced, broadband Internet access and could therefore harm Z-Tel s ability to provide services to its customers.

**FCC Regulation of Common Carrier Services**

In general, the FCC does not regulate the rates, services, and market entry and exit of non-dominant telecommunications carriers, but does require them to contribute to universal service and comply with other regulatory requirements. We are currently regulated as a non-dominant carrier with respect to both our local and long distance telephone services.

As a result, we currently are not subject to rate of return regulation at the federal level and are not currently required to obtain FCC authorization for the installation, acquisition or operation of our domestic exchange or interexchange network facilities. However, we must comply with the requirements of common carriage under the Communications Act of 1934. We are subject to the general requirement that our charges and terms for our telecommunications services be just and reasonable and that we not make any unjust or unreasonable discrimination in our charges or terms. The FCC has jurisdiction to act upon complaints against any common carrier for failure to comply with its statutory obligations. We are also subject to FCC rules that limit our ability to discontinue providing certain interstate services; however, the FCC has implemented a process that generally permits a company to discontinue such interstate services on an expedited basis.

Comprehensive amendments to the Communications Act of 1934 were made by the Telecommunications Act of 1996, which was signed into law on February 8, 1996. The Telecommunications Act effected changes in regulation at both the federal and state levels that affect virtually every segment of the telecommunications industry. The stated purpose of the Telecommunications Act is to promote competition in all areas of telecommunications.

*Interconnection and Unbundling Requirements.* The Telecommunications Act greatly expands the interconnection requirements applicable to the incumbent local exchange carriers, *i.e.*, generally, those existing local exchange carriers that, in the past, enjoyed virtual or legal monopoly status. The Telecommunications Act requires the incumbent local exchange carriers in connection with common carriers to

provide physical colocation, which allows companies such as us and other competitive local exchange carriers to install and maintain our own network termination equipment in incumbent local exchange carrier central offices or, if requested or if physical colocation is demonstrated to be technically infeasible, virtual colocation;

offer components of their local service networks on an unbundled basis so that other providers of local service can use these elements in their networks to provide a wide range of local services to customers; and

- establish wholesale rates for their services to promote resale by competitive local exchange carriers.

In addition, all local exchange carriers must

- interconnect with the facilities of other carriers;
- establish number portability, which will allow customers to retain their existing phone numbers if they switch from the local exchange carrier to a competitive local service provider;
- provide nondiscriminatory access to telephone poles, ducts, conduits and rights-of-way; and

compensate other local exchange carriers on a reciprocal basis for traffic originated by one local exchange carrier and terminated by another local exchange carrier.

The FCC is charged with establishing national guidelines to implement certain portions of the Telecommunications Act. The FCC s implementation of those provisions of the Act has been the subject of ongoing litigation that continues to this day. The litigation has focused upon two fundamental issues presented by the Act: the parts of the incumbent telephone networks that companies like Z-Tel can purchase on an unbundled basis, and the price such companies pays for those network elements. This section provides a history of that litigation and the risks that this ongoing litigation presents to us.

The FCC issued its first interconnection order on August 8, 1996. The FCC addressed both the unbundled access and pricing rules in this proceeding. In particular, among other decisions, the FCC established a list of seven network elements, comprising most of the significant facilities, features, functionalities, or capabilities of the network that the incumbent local exchange carriers must unbundle. It is possible for competitors to provide competitive local exchange service using only these unbundled network elements, by means of a combination that later became known as the Unbundled Network Element Platform, or UNE-P. In addition, the FCC mandated a particular forward looking pricing methodology for these network elements that produces relatively low element prices that are favorable to competitors.

Incumbent local telephone companies and state commissions appealed the FCC s 1996 Order to the United States Court of Appeals for the Eighth Circuit. In general, the Eighth Circuit addressed the FCC s pricing rules separately from the network access rules. On July 18, 1997, the Eighth Circuit issued a decision vacating the FCC s pricing rules, as well as certain other portions of the FCC s interconnection rules, on the grounds that the FCC had improperly intruded into matters reserved for state jurisdiction. On January 25, 1999, the Supreme Court, in *AT&T Corp. v Iowa Utilities Board*, largely reversed the Eighth Circuit s holding that the FCC has general jurisdiction to implement the local competition provisions of the Telecommunications Act. In so doing, the Supreme Court stated that the FCC has authority to set pricing guidelines for unbundled network elements, to prevent incumbent local exchange carriers from physically separating existing combinations of network elements, and to establish pick and choose rules regarding interconnection agreements. Pick and choose rules permit a carrier seeking interconnection to pick and choose among the terms of service from other interconnection agreements between the incumbent local exchange carriers and other competitive local exchange carriers. This Supreme Court action reestablished the validity of many of the FCC rules vacated by the Eighth Circuit.

Although the Supreme Court affirmed the FCC s authority to develop pricing guidelines, the Supreme Court did not evaluate the specific forward-looking pricing methodology mandated by the FCC and remanded the case to the Eighth Circuit for further consideration. Some incumbent local exchange carriers argued that this pricing methodology does not allow adequate compensation for the provision of unbundled network elements. The Eighth Circuit upheld the FCC s use of forward-looking incremental costs as the basis for establishing rates for interconnection and unbundled network elements. The Eighth Circuit further agreed with the FCC s interpretation of the Telecommunications Act as rejecting historical costs as the basis for setting rates. However, the Eighth Circuit vacated the FCC s regulation, codified at 47 C.F.R. Sec. 51.505(b), setting forth the FCC s approach to computing forward-looking incremental costs, and directed the FCC to review its approach so that it is based on the costs incurred by the incumbent local exchange carrier to provide the actual facilities and equipment that will be used by the requesting carrier instead of the lowest cost based on the most efficient technologies currently available. In 2001, the United States Supreme Court granted a writ of certiorari to the Eighth Circuit decision, and in 2002, the Supreme Court upheld the FCC s pricing rules.

Court consideration of the unbundled access rules followed a parallel track. In its January 25, 1999 *AT&T Corp. v. Iowa Utilities Board* ruling, the Supreme Court also remanded the list of unbundled network elements to the FCC for further consideration of the necessity of each one under the Telecommunications Act s statutory standard for unbundling. On November 5, 1999, the FCC released an order (referred to as the *UNE Remand Order)* that retained many of its original list of unbundled network elements, but providing further explanation of the need for such unbundling and eliminated the requirement that incumbent local exchange carriers provide unbundled access to operator services and directory assistance and limiting unbundled access to local switching in certain geographic areas. With regard to operator services and directory assistance, the FCC concluded that the market has developed since 1996 such that competitors can and do self-provision these services, or acquire them from alternative sources. The FCC also noted that incumbent local exchange carriers remain obligated under the non-discrimination requirements of the Communications Act of 1934 to comply with the reasonable request of a carrier that purchases these services from the incumbent local exchange carriers to rebrand or unbrand those services, and to provide directory assistance listings and updates in daily electronic batch files. With regard to unbundled local switching, the FCC concluded that, notwithstanding the incumbent local exchange carriers general duty to provide unbundled local circuit switching, an incumbent local exchange carrier is not required to unbundle local circuit switching for competitors in connection with end-users having four or more lines in certain high population density locations within the top 50 Metropolitan Statistical Areas, provided that the incumbent local exchange carrier provides nondiscriminatory access to combinations of unbundled loops and transport (also known as Enhanced Extended Links or EELs) throughout the high density area. For operator services and directory assistance, as well as for unbundled local switching, the FCC noted that the competitive checklist contained in Section 271 of the Communications Act of 1934 requires Bell operating companies to provide nondiscriminatory access to these services. Thus, Bell operating companies must continue to provide these services to competitors; however, Bell operating companies may charge different rates for these offerings.

The FCC s 1999 *UNE Remand Order* was appealed by several parties to the United States Court of Appeals for the D.C. Circuit, including incumbent local exchange carriers, *USTA v. FCC*. In addition, competitive carriers sought reconsideration of that decision, including the FCC s limitation on the availability of unbundled local switching, before the FCC. While that appeal was pending, the FCC, on December 20, 2001, released a Notice of Proposed Rulemaking in CC Dockets No. 01-338, 96-98 and 98-147 as part of its comprehensive Triennial Review of the 1999 *UNE Remand Order*. The FCC proposed to reexamine the availability of all unbundled network elements and to analyze that availability on a more specific basis. The FCC issued its Triennial Review order in September 2003.

While the Triennial Review proceeding was pending before the FCC, the D.C. Circuit ruled in the *USTA* appeal of the 1999 *UNE Remand Order.* The D.C. Circuit reversed the *UNE Remand Order* on the court s belief that the FCC had not taken into sufficient account the availability of substitutes for unbundled network elements from outside incumbent local telephone networks. The court called upon the FCC to engage in a detailed granular review as to whether any particular network element should be unbundled, based upon a specific analysis as to whether competitors could obtain comparable elements from other sources or whether a network element possessed natural monopoly characteristics. In addition, the D.C. Circuit required that the FCC balance the benefits of unbundling for competitors and consumers against the costs that unbundling might impose upon incumbent local telephone companies. Competitors filed for review of the *USTA* decision before the United States Supreme Court, but the U.S. Government and the FCC opposed that review, noting that while the Government and FCC believed that the *USTA* decision was inconsistent with the 1996 Act and the Supreme Court s *Verizon* decision, the proper course of action would be for the FCC to complete its already-pending *Triennial Review* rulemaking first. The Supreme Court denied the competitors request for an appeal.

In September 2003, the FCC released its final decision in the *Triennial Review* proceeding. In the *Triennial Review Order,* the FCC also ruled that entrants would no longer be able to access network elements utilized by incumbent local telephone companies to provide broadband services, such as fiber-to-the-premises loops, high-capacity (OCx) transport, packet switching, line-sharing for DSL services, and fiber-fed next-generation digital loop carrier (NGDLC) loops. These limitations on unbundled access could have a significant impact upon our business; if incumbent carriers deploy next-generation architectures as a replacement for their existing local plant, there is the significant possibility that our ability to provide services to our customers will be eliminated or severely restricted in such situations. The FCC did reaffirm incumbent local telephone company obligations to provide unbundled access to Enhanced Extended Links ( EELs, a combination of loop and transport) and the Unbundled Network Element Platform (UNE-P) combination in particular circumstances, subject to review by state public utility commissions. In particular, the FCC ruled that entrants like Z-Tel would be able to purchase dedicated transport (utilized in EELs) and analog switching (utilized in UNE-P) on an unbundled basis, subject to state-by-state review of whether such unbundling was needed in their states.

Carriers were involved in those state-by-state proceedings when, on March 2, 2004, the D.C. Circuit Court of Appeals overturned the FCC s decision as an improper delegation of authority to state public utility commissions. *See* Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, *Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd 16978 (2003) ( *Triennial Review Order* ), *rev d in part and remanded, United States Telecom Ass n v. FCC*, Nos. 00-1012, 00-1015, 03-1310 *et al.* (D.C. Cir. March 2, 2004) ( *USTA II* ). The D.C. Circuit ordered that the unbundled transport and switching rules be vacated after sixty days or upon denial of a petition for rehearing, whichever occurs later. A majority of the FCC has indicated that it will support an appeal of this decision. Z-Tel is weighing its legal options with regard to this opinion, as are other competitive carriers. If the *USTA II* decision is not stayed or reversed, it could have immediate, significant, adverse and material impact upon our business. For example, ILECs might utilize the reversal of the unbundling rules to deny us access to their local networks. We depend upon such access to provide our services to our customers. See section of this report entitled Risks Relating to Our Financial Condition and Our Business.

We believe that in the event the rules are vacated without any replacement by either the FCC or the state utility commissions, we have interconnection agreements with our principal ILEC vendors that will permit us to continue to obtain access to local network elements during any intervening time period. However, it is possible that any or all of those ILECs will refuse to abide by the terms of those agreements or seek to terminate those agreements. We are evaluating our legal options to ensure that we continue to meet the needs of our existing and future customers.

Other pending matters before the FCC also could impact our business. In particular, on December 20, 2001, the FCC issued a Notice of Proposed Rulemaking in CC Docket No. 01-337 in which the FCC sought comment on regulatory requirements for incumbent local exchange carrier provision of broadband telecommunications services. In this proceeding, the FCC is considering whether it should remove regulatory safeguards and common carrier obligations, including unbundling regulations, on incumbent local exchange carrier broadband networks. An FCC decision limiting unbundling or deregulating incumbent local exchange carrier broadband networks could have a significant and material adverse impact on our business. For example, incumbent local exchange carriers may be able to offer consumers deregulated broadband network packages of local exchange, information services and broadband service (such as DSL) that Z-Tel would not be able to offer because Z-Tel would not have unbundled access to that broadband network. In addition, because the incumbent local exchange carrier broadband network in most instances utilizes the same network facilities as the current incumbent local exchange dial tone network, limitations on unbundling or deregulation of that broadband network could make it difficult, more costly, or even impossible for Z-Tel to provide its current telecommunications and information services to consumers.

These and other FCC determinations are likely to be the subject of further appeals or reconsideration. Thus, while the Supreme Court has resolved many issues, including aspects of the FCC s jurisdictional authority, other issues remain subject to further consideration by the courts and the FCC. We cannot predict the ultimate disposition of these matters.

*Interconnection Agreements.* The Telecommunications Act obligates incumbent local exchange carriers to negotiate with us in good faith to enter into interconnection agreements. Competitive local exchange carriers like us can purchase unbundled network elements under such an agreement or under a tariff or a Statement of Generally Available Terms filed with the state regulators. Interconnection agreements are the principal means of obtaining access to the incumbent local exchange carrier s unbundled network elements and providing the connectivity to our network necessary to provision local exchange services, including Z-LineHOME. To this end, we have entered into interconnection agreements with the Bell operating company in all states where we currently offer local exchange services.

To ensure that it obtains interconnection and unbundled access at the best-available terms, Z-Tel currently is reviewing available contracts or negotiating new contracts in a number of states. However, at any point in time our interconnection agreement may not contain the best-available terms offered to our competitors, a situation that could adversely affect our ability to compete in the market. In addition, several of our interconnection agreements with Verizon, SBC and BellSouth have expired. However, the terms of those contracts provide for the agreements to continue on a month-to-month basis until a replacement is executed.

Section 252 of the Telecommunications Act of 1996 contains a specific process for negotiating and arbitrating interconnection agreements with incumbent local telephone companies. If we cannot reach a voluntary interconnection agreement with an incumbent local exchange carrier on acceptable terms, either side may petition the applicable state commission to arbitrate remaining disagreements. These arbitration proceedings can last for a substantial period of time and can require substantial resources to litigate. Moreover, state commission approval of any interconnection agreement resulting from negotiation or arbitration is required, and any party may appeal an adverse decision by the state commission to federal district court. The incentive of the incumbent local exchange carrier to negotiate fair or proper interconnection agreement terms is a function of the willingness and authority of state commissions and the FCC to enforce rules and policies promulgated under the Telecommunications Act. The potential cost in resources and delay from this interconnection agreement negotiation and arbitration process could harm our ability to compete in certain markets, and there is no guarantee that a state commission would resolve disputes, including pricing disputes, in our favor.

The ability of a new entrant like Z-Tel to enforce interconnection agreements with incumbent local exchange carriers or appeal state commission arbitrations regarding such agreements is currently subject to considerable legal uncertainty. A January 2002 decision by the United States Circuit Court for the Eleventh Circuit ruled that the Georgia state commission did not have authority to enforce interconnection agreements between incumbent local exchange carriers and new entrants. This decision is in apparent conflict with decisions by other United States Circuit Courts. As a result of this decision, our costs associated with litigating enforcement of interconnection agreements in state or federal courts in the Eleventh Circuit and elsewhere could substantially increase. A November 2003 decision by the United States Circuit Court for the Fifth Circuit ruled that state commission jurisdiction to arbitrate terms and conditions of access pursuant to section 252 may relate only to items specifically-related to section 251 of the 1996 Act and other items voluntarily negotiated by the parties. That decision could limit our ability to arbitrate acceptable interconnection terms with incumbent local telephone companies before state commissions; at the same time, that decision could enhance our ability to resist inclusion of clauses in our contracts by those incumbents that we deem unacceptable.

*Colocation.* The FCC has adopted rules designed to make it easier and less expensive for competitive local exchange carriers to colocate equipment at incumbent local exchange carriers central offices by, among other things, restricting the incumbent local exchange carriers ability to prevent certain types of equipment from being colocated and requiring incumbent local exchange carriers to offer alternative colocation arrangements. Restrictions and impediments to colocation could harm our business as they make it more difficult if not impossible for us to obtain alternatives to unbundled network elements we purchase from incumbent local exchange carriers.

On March 17, 2000, the United States Court of Appeals for the District of Columbia Circuit vacated portions of the FCC s colocation rules. Specifically, the court found that the FCC s interpretations of the statutory terms necessary and physical colocation were impermissibly broad, and remanded those portions of the order to the FCC for reconsideration. On August 8, 2001, the FCC released an order on remand in response to this D.C. Circuit decision in CC Docket 98-147. The FCC decided that competitors may colocate equipment in incumbent local exchange carrier central offices if the competitor, as a practical, economic or operational matter would be precluded form obtaining equal in quality interconnection or nondiscriminatory access to unbundled network elements. The FCC limited which multi-functional equipment competitors may colocate. The FCC also decided that incumbent local exchange carriers must comply with reasonable requests for competitors to install and maintain cross-connections with colocated equipment of other competitors. The FCC also decided that incumbent local exchange carriers may decide where colocated equipment may be placed within its premises as long as the incumbent local exchange carrier acts reasonably and non-discriminatorily. The FCC also determined that except in limited circumstances, an incumbent local exchange carrier may separate the space colocators. The FCC s new colocation rules could increase the cost and time for competitors to colocate equipment in incumbent local exchange carrier central offices and could have a substantial and material impact on Z-Tel s future business prospects. This FCC Colocation Remand Order is currently on appeal to the D.C. Circuit. The outcome of that subsequent appeal is uncertain and could impact Z-Tel s business.

*Line Sharing and Line Splitting*. On November 18, 1999, the FCC adopted an order requiring incumbent local exchange carriers to provide line sharing, which is a method in which a competitive local exchange carrier offers data services over the same line that a consumer uses for voice services without the competitive local exchange carriers having to provide the voice service. In an Order on Reconsideration, issued January 19, 2001, the FCC reaffirmed its prior decision to support line sharing for provision of digital subscriber line (DSL) services. In addition, in this January 19, 2001 decision, the FCC stated that incumbent local exchange carriers must permit competitive local exchange carriers to engage in line splitting arrangements, where a competitive local exchange carrier provides voice and another provides data service to end-users over a split loop purchased as an unbundled network element from the incumbent local exchange carrier. While we expect that the FCC s rules will be beneficial to competitive local exchange carriers, we cannot be certain that these rules will be implemented by the incumbent local exchange carrier in a timely or favorable manner. As a result, Z-Tel s ability to offer its customers DSL service and voice service by use of line-splitting and the unbundled network element platform combination is restricted significantly by incumbent local exchange carriers. That restriction could harm our business and our ability to match the service packages and bundles offered by our competitors. Moreover, in light of the FCC s Further Notice of Proposed Rulemaking issued in conjunction with its January 19, 2001 Order on Reconsideration, several key issues regarding line sharing, including the provision of line sharing in instances where loop facilities have fiber components and where remote terminals do not have sufficient space for colocation, remain. Any decision by the FCC in these proceedings could limit Z-Tel s unbundled access to the incumbent local exchange carrier networks in a manner that could have a substantial and material impact on our current or future business.

*Bell Operating Company Entry into the Long Distance Market.* The Telecommunications Act permitted the Bell operating companies to provide long distance services outside their local service regions immediately, and permits them to provide in-region long distance service upon demonstrating to the FCC that they have adhered to the Telecommunication Act s Section 271 14-point competitive checklist. The FCC must also find that granting the application would be in the public interest. As of this writing, Bell companies had received long-distance authority in all 48 states within the continental U.S. Z-Tel is currently appealing the FCC s grant of authority to SBC/Ameritech for Illinois, Wisconsin, Indiana and Ohio on the basis that SBC s application and the FCC s approval was predicated upon the availability of UNE-P and the availability of unbundled switching throughout all of those states. Z-Tel s appeal is pending before the D.C. Circuit and consideration of that appeal is currently being held in abeyance, at Z-Tel s request, pending resolution of the *USTA II* decision. Now that the D.C. Circuit has ruled in *USTA II*, we expect that our appeal of the SBC/Ameritech Section 271 authorizations will proceed expeditiously. Z-Tel believes that because the D.C. Circuit vacated the FCC s unbundled local switching rules in *USTA II*, the D.C. Circuit should reverse the FCC s grant of long-distance authority to SBC/Ameritech in these states, as the FCC s grant was predicated upon the availability of unbundled local switching to entrants in those states.

With Bell operating companies authorized to provide long-distance service nationwide, it is generally expected that competition for Z-Tel s local and long-distance services will increase. Section 271 entry permits the Bell operating company to offer a bundle of local, long-distance and enhanced services comparable to Z-Tel s services and therefore could increase competition and harm our business, especially if we cannot obtain adequate access to unbundled network elements from that same Bell operating company.

At the same time, the Section 271 process also provides an important ongoing incentive for Bell operating companies to comply with the unbundling and interconnection requirements of the Telecommunications Act. The section 271 competitive checklist specifically requires Bell companies to provide competitors access to loop transmission, switching, transport and signaling. In the *Triennial Review Order*, the FCC ruled that these section 271 checklist requirements were independent legal obligations with which Bell companies must comply, regardless of the status of the unbundling rules under section 251. In the *USTA II* decision, the D.C. Circuit characterized this independent legal obligation as a reasonable approach. We will vigorously enforce its rights to access to Bell company networks pursuant to the independent legal authority that the section 271 checklist requires.

*Universal Service.* In May 1997, the FCC released an order establishing a significantly expanded universal service regime to subsidize the cost of telecommunications service to high cost areas, as well as to low-income customers and qualifying schools, libraries and rural health care providers. Providers of interstate telecommunications services, like us, as well as certain other entities, must pay for these programs. We are also eligible to receive funding from these programs if we meet certain requirements.

Table of Contents

Our share of the payments into these subsidy funds is based on our share of certain defined interstate telecommunications end-user revenues. Currently, the FCC is assessing such payments on the basis of a provider s revenue for the previous year. The FCC adjusts payment requirements and levels periodically. Various states are also in the process of implementing their own universal service programs. We are currently unable to quantify the amount of subsidy payments that we will be required to make to individual states.

On July 30, 1999, the United States Court of Appeals for the Fifth Circuit overturned certain of the FCC s rules governing the basis on which the FCC collects subsidy payments from telecommunications carriers and recovery of those payments by incumbent local exchange carriers. In October 1999, on remand, the FCC issued new universal service rules. Other changes to the universal service program could affect our costs.

The FCC rules are pending review before the Fifth Circuit. The outcome of that litigation and subsequent and forthcoming FCC and state determinations could adversely impact or delay our ability to obtain universal service funding for our services or our ability to compete with carriers that do obtain such funding. The FCC is also seeking comment on how to assess and collect funds from carriers to support the universal service system. Changes to this support program could adversely affect our costs, our ability to separately-list these charges on end-user bills, and our ability to collect these fees from our customers.

*Interstate Tariffs and Rates.* Beginning July 31, 2001, interstate domestic long distance companies were no longer allowed to file interstate long-distance end-user tariffs with the FCC. This regulatory change requires that Z-Tel make its long-distance service information directly available to customers pursuant to private contracts. In March 1999, the FCC adopted rules that require interexchange (long distance) carriers like Z-Tel to make specific disclosures on their web sites of their rates, terms and conditions for domestic interstate services.

On April 27, 2001, the FCC limited the ability of nondominant, competitive local exchange carriers, including Z-Tel, to file tariffs for interstate switched access services. In doing so, the FCC effectively regulates the rates Z-Tel charges long-distance companies for interstate switched access services. Local exchange carriers (like Z-Tel) provide interstate switched access services to interexchange long-distance companies (like AT&T, MCI and Sprint, as well as Z-Tel) when a state-to-state long distance call is made to or placed by a local telephone customer. Given the large number of interstate long-distance companies, these interstate switched access services are provided generally through FCC interstate tariffs. Prior to this April 27, 2001 decision, the FCC had refrained from any price regulation of the interstate access rates of competitive local exchange companies like Z-Tel. With the April 27, 2001 Report and Order in CC Docket No. 96-262, the FCC ruled that it would not accept for filing any interstate switched access tariff filing by a competitive local exchange carrier if the per-minute rate exceeded an FCC benchmark. The FCC benchmark varies by metropolitan statistical area. In metropolitan statistical areas ( MSAs ) that a competitive local exchange carrier began to provide service after June 20, 2001 (the effective date of the Order), the FCC benchmark rate is the interstate switched access rate for the competing incumbent local exchange carrier, which is established pursuant to publicly-filed tariffs before the FCC. For MSAs in which a carrier was providing local service as of June 20, 2001, the FCC benchmark rate from June 20, 2001 through June 19, 2002 was 2.5 cents per minute or the competing incumbent local exchange carrier rate, whichever is higher. For those same MSAs, the FCC benchmark rate from June 20, 2002 through June 19, 2003 was 1.8 cents per minute or the competing incumbent local exchange carrier rate, whichever is higher. For those same MSAs, the FCC benchmark rate from June 20, 2003 through June 19, 2004 is 1.2 cents per minute or the competing incumbent local exchange carrier rate, whichever is higher. Beginning on June 20, 2004, the FCC benchmark rate for those MSAs will be the switched access rate of the competing incumbent local exchange carrier. As of June 20, 2001, Z-Tel was providing local service in most of the MSAs in its current footprint; as a result, the FCC benchmark rates for Z-Tel s interstate switched access charges in those MSAs will, through June 20, 2004, be considerably higher than the FCC benchmark rate for Z-Tel s competitors that began to provide service in those MSAs after June 20, 2001.

AT&T and Sprint have appealed the FCC s April 2001 CLEC Access Charge Order before the United States Circuit Court for the District of Columbia, arguing that the FCC s benchmark rates are too high and that competitive local exchange carriers like Z-Tel should be required to provide interstate switched access services at the competing incumbent local exchange carrier rate immediately. Z-Tel has intervened in that court proceeding against those long-distance companies. Two competitive local exchange carriers have also appealed the FCC decision, and several competitive carriers have sought reconsideration or clarification of the FCC s decision. In addition, Z-Tel has sought a waiver of FCC rules requiring it to tariff interstate switched access services at the competing incumbent local exchange carrier rate for several dozen smaller MSAs that Z-Tel did not have any local subscribers in as of June 20, 2001, arguing to the FCC that the cost to Z-Tel to provide interstate switched access services at two different rate levels in the same state would impose unnecessary costs on Z-Tel that is inconsistent with the public interest. These appeals, reconsiderations, and the waiver request are all pending. The outcome of any of these determinations could have a significant and material impact on Z-Tel s business.

In 2001, Z-Tel settled pending litigation with AT&T and Sprint over their nonpayment of access charges to Z-Tel. Z-Tel provides interstate and intrastate switched access services to both of those long-distance carriers pursuant to switched access service agreements. Based on history of nonpayment of both of these long-distance carriers to Z-Tel, there is a risk that either or both of these long-distance companies could fail to pay Z-Tel for switched access services. While Z-Tel has in the past and will in the future adamantly litigate and defend its position against these carriers, nonpayment could have a substantial and material adverse impact on our business.

*Numbering and Number Portability.* In August 1997, the FCC issued rules transferring responsibility for administering and assigning local telephone numbers from the Bell operating companies and other incumbent local exchange carriers to a neutral entity in each geographic region in the United States. In August 1996, the FCC issued new numbering regulations that prohibit states from creating new area codes that could unfairly hinder competitive local exchange carriers by requiring their customers to use 10 digit dialing while existing incumbent local exchange carrier customers use seven digit dialing. In addition, each carrier is required to contribute to the cost of numbering administration through a formula based on net telecommunications revenues. Beginning in March 2000, contributions for this purpose were based on end-user telecommunications revenues and have been submitted in association with FCC Lifeline, Universal Service and the Schools and Libraries Funds.

In July 1996, the FCC released rules requiring all local exchange carriers to have the capability to permit both residential and business consumers to retain their telephone numbers when switching from one local service provider to another, known as number portability. Number portability has been implemented in most of the areas in which we provide service, but has not been implemented everywhere in the United States. Some carriers have obtained waivers of the requirement to provide number portability, and others have delayed implementation by obtaining extensions of time before compliance is required. Lack of number portability in a given market could adversely affect our ability to attract customers for our competitive local exchange service offerings, particularly business customers, should we seek to provide services to such customers in those markets. In 2003, the FCC established number portability rules for wireless carriers that require landline telephone companies to port numbers to customer s wireless services. Wireless number portability has been implemented in most major U.S. metropolitan areas and FCC rules require that it be implemented nationwide. The FCC has also proposed rules that would require wireless carriers to port numbers to landline carriers like Z-Tel. If the FCC does not implement congruent porting rules on wireless carriers that are currently applicable to landline carriers, our ability to compete with wireless carriers in providing bundles or packages of wireline and wireless services could be adversely affected.

In May 1999, the FCC also initiated a proceeding to address the problem of the declining availability of area codes and phone numbers. On December 29, 2000, the FCC issued a Further Notice of Proposed Rulemaking in CC Dockets No. 96-98 and 99-200 that proposed adoption of a market-based approach for optimizing number resources. In that Further Notice the FCC seeks input on its tentative conclusion that, through the introduction of charges associated with the allocation of number resources, carriers might be better incentivized to take and retain only as many numbers as they need. If a market-based approach to number allocation is introduced, as the FCC has proposed, it could result in added administrative expenses for us.

*Restrictions on Bundling.* Current FCC rules prohibit dominant carriers from bundling their non-competitive regulated telecommunications services with their unregulated enhanced or information services. To our knowledge, the FCC has not enforced this rule with respect to competitive local exchange carriers and has proposed eliminating the rule for all carriers.

*Slamming.* A customer s choice of local or long distance telecommunications company is encoded in a customer record, which is used to route the customer s calls so that the customer is served and billed by the desired company. A user may change service providers at any time, but the FCC and some states regulate this process and require that specific procedures be followed. When these procedures are not followed, particularly if the change is unauthorized or fraudulent, the process is known as slamming. Slamming is such a significant problem that it has been addressed in detail by Congress in the Telecommunications Act, by some state legislatures, and by the FCC in recent orders. The

FCC has levied substantial fines for slamming. The risk of financial damage, in the form of fines, penalties and legal fees and costs, and to business reputation from slamming is significant. Even one slamming complaint could cause extensive litigation expenses for us. The FCC recently decided to apply its slamming rules (which originally covered only long distance) to local service as well. Z-Tel is also subject to state rules and regulations regarding slamming, cramming, and other consumer protection regulation.

*Network Information.* Section 222 of the Communications Act of 1934 and FCC rules protect the privacy of certain information about telecommunications customers that a telecommunications carrier such as us acquires by providing telecommunications services to such customers. Such protected information, known as Customer Proprietary Network Information (CPNI), includes information related to the quantity, technological configuration, type, destination and the amount of use of a telecommunications service. The FCC s original rules prevented a carrier from using CPNI acquired through one of its offerings of a telecommunications service to market certain other services without approval of the affected customer. The United States Court of Appeals for the Tenth Circuit overturned a portion of the FCC s rules established in CC Docket No. 96-115 regarding the use and protection of CPNI.

In response to the Tenth Circuit decision, in October 2001, in CC Docket No. 96-115, the FCC clarified that the Tenth Circuit reversal was limited and that most of the FCC s CPNI rules remained in effect. The FCC sought further comment on what method of customer consent offered by a carrier (either an opt-in or opt-out approach) would serve the governmental interest in Section 222 and be consistent with the First Amendment. The final determination of this issue and other FCC rules regarding

**Table of Contents**

handling of CPNI could result in significant administrative expense to Z-Tel in modifying internal customer systems to meet these requirements.

*Intercarrier Compensation (Interstate Access Charges and Reciprocal Compensation).* Because Z-Tel, as a competitive local exchange carrier, passes and receives local and toll calls to and from other local exchange carriers and long-distance companies, the rates for intercarrier compensation for these calls has a significant and substantial impact on the profitability of our business. In addition, the rates that our competitors, especially the incumbent local exchange carriers, are permitted to charge end-users, other local exchange carriers, and long-distance companies for originating, transmitting, and terminating telecommunications traffic can have a substantial impact on our ability to offer services in competition with those carriers.

The current regulatory (and intercarrier compensation) status of dial-up calls to Internet service providers is in dispute and litigation. The FCC has determined that both continuous access and dial-up calls from a customer to an Internet service provider are interstate, not local, calls, and, therefore, are subject to the FCC s jurisdiction. The FCC has initiated a proceeding to determine the effect that this regulatory classification will have on the obligation of local exchange carriers to pay reciprocal compensation for dial-up calls to Internet service providers that originate on one local exchange carrier network and terminate on another local exchange carrier network. Moreover, many states have or are considering this issue, and several states have held that local exchange carriers do not need to pay reciprocal compensation for calls terminating at Internet service providers. A majority of state commissions have ruled that reciprocal compensation should be paid on such traffic. On March 24, 2000, the Court of Appeals for the District of Columbia remanded for reconsideration the FCC s determination that calls to Internet service providers are interstate for jurisdictional purposes rather than local. Specifically, the Court indicated that the FCC has not provided a satisfactory explanation why calls to Internet service providers are not local telecommunications traffic and why such traffic is exchange access rather than telephone exchange service. We cannot predict the effect that the FCC s resolution of these issues will have on our business.

Since passage of the Telecommunications Act of 1996, the FCC has fundamentally restructured the access charges that incumbent local exchange carriers charge to interexchange carriers and end-user customers to connect to the incumbent local exchange carrier s network. The FCC revised access charges for the largest incumbent local exchange carriers in May 1997, reducing per-minute access charges and increasing flat-rated monthly charges paid by both long-distance carriers and end-users. Further changes in access charges were effected for the largest incumbent local exchange carriers when the FCC adopted the Coalition for Affordable Local and Long-Distance Service ("CALLS") proposal in May 2000. CALLS, which reflected a negotiated settlement between AT&T and most of the Bell operating companies, reduced per-minute charges by 60 percent. It further increased flat-rated monthly charges to end-users, in particular, multi-line business users. The CALLS plan also attempted to remove implicit universal service subsidies paid for by long-distance companies in interstate access rates and place those funds into the federal universal service support system, where they would be recovered from all interstate carriers. Most of the reductions in the CALLS plan resulted from shifting access costs away from interexchange carriers onto end-user customers. Last year, the Fifth Circuit reversed and remanded portions of the CALLS plan back to the FCC for further consideration of the issue as to the size of the subsidy for universal service should be removed from the interstate access charges and placed into the federal interstate universal service support system. The outcome of this litigation could impact the contributions Z-Tel, as an interstate carrier, must pay to support the federal universal service support system.

In addition, as discussed above, the rates that Z-Tel and other competitive local exchange carriers may charge for interstate switched access services are regulated pursuant to the FCC s April 2001 CLEC Access Charge Order.

In April 2001, the FCC released a Notice of Proposed Rulemaking in CC Docket No. 01-92 in which it proposed a fundamental re-examination of all currently regulated forms of intercarrier compensation. The FCC proposed that carriers transport and terminate local traffic on a bill-and-keep basis, rather than per-minute reciprocal compensation charges. The FCC regards the CALLS Order and the CLEC Access Charge Order as well as its reciprocal compensation rules to be 3-year "transitional intercarrier compensation regimes." After completion of that three-year transition, a new interstate intercarrier compensation regime based upon bill-and-keep or another alternative may be in place. Because Z-Tel both makes payments to and receives payments from other carriers for exchange of local and long-distance calls, at this time we cannot predict the effect that the FCC s determination in CC Docket No. 01-92 may have upon our business.

*Potential Legislation*. Changes to the market-opening and enforcement provisions of the Communications Act of 1934 or the Telecommunications Act of 1996 could adversely affect our ability to provide competitive services and could harm our business. No substantial re-write of either Act has been introduced before the U.S. Congress as of this writing.

*Other Issues.* There are a number of other issues and proceedings that could have an effect on our business in the future, including the following facts.

The FCC has adopted rules to require telecommunications service providers to make their services accessible to individuals with disabilities, if readily achievable.

In March, 2004, the Department of Justice filed a rulemaking petition before the FCC that asks for new rules to

Table of Contents

implement the Communications Assistance with Law Enforcement Act ("CALEA"). CALEA requires telecommunications providers to design and engineer their networks to permit law enforcement agencies to wiretap and obtain customer service information (e.g., call trace, call records). The Department of Justice CALEA Petition proposes to extend many of those requirements to information services as well. Implementation of the proposed CALEA rules could have a significant impact upon our ability to provide both regulated common carrier and information services to our customers. Such rules could increase the cost of equipment we purchase to deploy our services and such rules could also delay the availability of equipment we need. We cannot predict any such delays or the potential cost at this time. Current FCC rules require telecommunications service providers to provide law enforcement personnel with a sufficient number of ports and technical assistance in connection with wiretaps. We cannot predict the cost to us of complying with these rules at this time.

The FCC has adopted new rules designed to make it easier for customers to understand the bills of telecommunications carriers. These Truth-in-Billing rules establish certain requirements regarding the formatting of bills and the information that must be included on bills.

We are subject to annual regulatory fees assessed by the FCC, and must file an annual employment report to comply with the FCC s Equal Employment Opportunity policies.

The FCC has adopted an order granting limited pricing flexibility to large incumbent local exchange carriers, and is considering granting additional pricing flexibility and price deregulation options. These actions could increase competition for some of our services.

The foregoing is not an exhaustive list of proceedings or issues that could materially affect our business. We cannot predict the outcome of these or any other proceedings before the courts, the FCC, legislative bodies, or state or local governments.

**STATE REGULATION**

To the extent that we provide telecommunications services that originate and terminate within the same state, we are subject to the jurisdiction of that state s public service commission. As our local service business and product lines expand, we will offer more intrastate services and may become increasingly subject to state regulation. The Telecommunications Act maintains the authority of individual state utility commissions to preside over rate and other proceedings, and to impose their own regulation on local exchange and intrastate interexchange services, so long as such regulation is not inconsistent with the requirements of federal law. For instance, states may require us to obtain a Certificate of Public Convenience and Necessity before commencing service in the state. We have obtained such authority in all states in which we operate, and, as a prelude to market entry in additional states, we have obtained such authority to provide local service in 49 states and the District of Columbia.

In addition to requiring certification, state regulatory authorities may impose tariff and filing requirements, consumer protection measures, and obligations to contribute to universal service and other funds. State commissions also have jurisdiction to approve negotiated rates, or establish rates through arbitration, for interconnection, including rates for unbundled network elements. Changes in those rates for unbundled network elements could have a substantial and material impact on our business.

We are subject to requirements in some states to obtain prior approval for, or notify the state commission of, any transfers of control, sales of assets, corporate reorganizations, issuance of stock or debt instruments and related transactions. Although we believe such authorizations could be obtained in due course, there can be no assurance that state commissions would grant us authority to complete any of these transactions.

We are also subject to state laws and regulations regarding slamming, cramming, and other consumer protection and disclosure regulations. These rules could substantially increase the cost of doing business in any one particular state. State commissions have issued or proposed several substantial fines against competitive local exchange companies for slamming or cramming. The risk of financial damage, in the form of fines, penalties and legal fees and costs, and to business reputation from slamming is significant. Even one slamming complaint before a state commission could cause extensive litigation expenses for us. In addition, state law enforcement authorities may utilize their powers under state consumer protection laws against us in the event legal requirements in that state are not met.

Z-Tel s rates for intrastate switched access services, which Z-Tel provides to long-distance companies to originate and terminate in-state toll calls, are subject to the jurisdiction of the state commissions in which the call originated and terminated. State commissions may, like Texas, directly regulate or prescribe this intrastate switched access rate. Such regulation by other states could materially and adversely affect Z-Tel s revenues and business opportunities within that state.

The Telecommunications Act generally preempts state statutes and regulations that restrict the provision of competitive services. As a result of this preemption, we will be generally free to provide the full range of local, long distance, and data services in any state. While this action greatly increases our potential for growth, it also increases the amount of competition to which we may be subject. States, however, may still restrict Z-Tel s ability to provide competitive services in some rural areas. In addition, the cost of enforcing federal preemption against certain state policies and programs may be large and may cause considerable delay. As we roll out new services on a state-by-state basis, we anticipate that the incumbent local exchange carrier will provide the unbundled network element platform components in a manner similar to that provided in states where we currently operate. However, pricing and terms and conditions adopted by the incumbent local exchange carrier in each of these states may preclude our ability to offer a competitively viable and profitable product within these and other states on a going-forward basis. In order to enter new markets, we may be required to negotiate interconnection agreements with incumbent local exchange carriers on an individual state basis. To continue to provide service, we also need to renegotiate interconnection agreements with incumbent local exchange carriers. While current FCC rules and regulations require the incumbent provider to provide the network elements on an individual and combined basis necessary for us to provision end-user services, no assurance can be made that the individual local exchange providers will provide these components in a manner and at a price that will support competitive operations. If the incumbent providers do not readily provide network functionality in the manner required, we have regulatory and legal alternatives, including arbitration before state public service commissions, to force provision of services in a manner required to support our service offerings. However, if we are forced to litigate in order to obtain the combinations of network elements required to support our service, we are likely to incur significant incremental costs and delays in entering such markets. In addition, as discussed above, there is considerable legal uncertainty as to how interconnection agreements are to be enforced before state commissions and where appeals of state commission interconnection agreement determinations may be heard.

State legislatures also may impact our business. In 2003, the Illinois General Assembly passed a law that ordered the Illinois Commerce Commission to increase unbundled network elements rates. Z-Tel and several other competitive carriers filed a lawsuit and injunction against that law, on the basis that the Telecommunications Act of 1996 ordered state commissions not state legislatures to establish rates for network elements. The U.S. District Court for the Northern District of Illinois and, subsequently, the United States Circuit Court of Appeals for the Seventh Circuit, agreed and ordered a permanent injunction against the Illinois statute. Nevertheless, incumbent local telephone companies actively lobby and support legislation that would curtail the roles of state public utility commissions, limit competitive access laws that may exist at the state level that may go beyond the Telecommunications Act, or otherwise limit the ability of competitive companies like Z-Tel to compete against incumbents or obtain access to local networks at just, reasonable and nondiscriminatory rates. At any point in time, several such bills are pending before the state legislatures of states in which we do business, and passage of such legislation could have a significant and material effect on our ability to do business in that particular state.

## LOCAL GOVERNMENT REGULATION

In some of the areas where we provide service, we may be subject to municipal franchise requirements requiring us to pay license or franchise fees either on a percentage of gross revenue, flat fee or other basis. We may be required to obtain street opening and construction permits from municipal authorities to install our facilities in some cities. The Telecommunications Act prohibits municipalities from discriminating among telecommunications service providers in imposing fees or franchise requirements. In some localities, the FCC has preempted fees and other requirements determined to be discriminatory or to effectively preclude entry by competitors, but such proceedings have been lengthy and the outcome of any request for FCC preemption would be uncertain.

## COMPETITION

### Overview

The telecommunications industry is highly competitive. However, at present, we believe few telecommunications carriers provide the type of bundled service packages that include the range of services and features that we offer, but various competitors offer one or more of the services that make up our service offerings. Competition in the local telephone services market arises primarily from the ILECs and alternative transport systems such as wireless, cable and the Internet. Competition in the long distance and information services markets, which have fewer entry barriers, is already intense and is expected to remain so.

We believe the principal competitive factors affecting our business will be the quality and reliability of our services, customer confidence, innovation, customer service and price. Our ability to compete effectively will depend upon our continued ability to offer innovative, high-quality, market-driven services at prices generally equal to or below those charged by our competitors and to instill confidence in prospective customers as to our long-term viability and the viability of our access to ILEC and other networks. Many of our current and potential competitors have far greater financial, marketing, personnel and other resources than we do, as well as other competitive advantages.

**Local Telephone Service**

**Incumbent Local Exchange Carriers.** In each of our target markets, we will compete with the incumbent local exchange carrier serving that area, which may be one of the Bell operating companies. The incumbent local exchange carriers have long-standing relationships with their customers, have financial, technical and marketing resources substantially greater than ours, have the potential to subsidize services that compete with our services with revenue from a variety of other unregulated businesses, and currently benefit from certain existing regulations that favor the incumbent local exchange carriers over us in certain respects.

Table of Contents

Also as stated above under Government Regulation, a recent court ruling has created uncertainty in the ILECs and our regulatory environment. This uncertainty favors the ILECs and may enable them to raise fees they charge to us, thereby causing us to raise our rates to non-competitive levels.

Regulations that allow competitive local exchange carriers, such as us, to interconnect with incumbent local exchange carrier facilities and acquire and combine the unbundled network elements of an incumbent local exchange carrier provide increased business opportunities for us. However, such interconnection opportunities have been, and will likely continue to be, accompanied by increased pricing flexibility and relaxation of regulatory oversight for the incumbent local exchange carriers.

**Competitive Local Exchange Carriers.** We face competition in local telephone services from numerous competitive local exchange carriers, including our own wholesale customer Sprint. Interexchange (long distance) carriers such as AT&T, MCI and Sprint have entered the local telephone market. These companies have name recognition, standing relationships with their customers and financial, technical and marketing resources substantially greater than we have. The Telecommunications Act radically altered the market opportunity for competitive local exchange carriers. With the required unbundling of the incumbent local exchange carrier s networks, competitive local exchange carriers are able to enter the market more rapidly by leasing switches, trunks and loop capacity until traffic volume justifies building substantial facilities. Newer competitive local exchange carriers, like us, will not have to replicate existing facilities and can be more opportunistic in designing and implementing networks, which could have the effect of increasing competition for local exchange services.

**Cable Television Operators.** Cable television operators are also entering the telecommunications market by upgrading their networks with fiber optics and installing facilities to provide fully interactive transmission of broadband voice, video and data communications. These companies have standing relationships with their customers and generally have financial, technical and marketing resources substantially greater than we have.

**Wireless Telephone Companies.** Wireless telephone systems are seen by many consumers as a substitute for traditional wireline local telephone service. Wireless companies have name recognition, standing relationships with their customers and financial, technical and marketing resources substantially greater than we have.

**VoIP Providers.** The Internet is being used by a limited number of consumers as a substitute for traditional wireline local and long distance telephone service. The number of VoIP users could expand rapidly in the near future. We intend to offer our own VoIP services. Other entrants into this market may include ILECs, cable television operators and Internet service providers as well as new entrants.

**New Entrants.** We could face competition from new entrants into the local exchange market. Because the Telecommunications Act requires the unbundling of the incumbent local exchange carrier s networks, new entrants are able to enter the market by leasing switches, trunks and loop capacity in lieu of expending funds building substantial facilities. This lower barrier to entry could have the effect of increasing competition for local exchange services. Moreover, a continuing trend toward consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors.

**Long Distance Telephone Service**

The long distance telecommunications industry has numerous entities competing for the same customers and a high average churn rate because customers frequently change long distance providers in response to the offering of lower rates or promotional incentives by competitors. Our primary competitors in the long distance market include major interexchange carriers such as AT&T, MCI and Sprint, certain incumbent local exchange carriers and resellers of long distance services. We believe that pricing levels are a principal competitive factor in providing long distance telephone service. We hope to avoid direct price competition by bundling long distance telephone service with a wide array of value-added, enhanced communications services.

We believe that incumbent local exchange carriers that offer a package of local, long distance telephone and information services will be particularly strong competitors. Incumbent local exchange carriers, including Verizon, BellSouth, Qwest and SBC Communications, are currently providing both long distance and local services as well as certain enhanced telephone services that we offer. We believe that the Bell operating companies will attempt to offset market share losses in their local markets by attempting to capture a significant percentage of the long distance market.

**Enhanced Communications Services**

We compete with a variety of enhanced service companies. Enhanced communications services markets are highly competitive, and we expect that competition will continue to intensify. Our competitors in these markets include Internet service providers, Web-based communications service providers and other telecommunications companies, including the major interexchange carriers, incumbent local exchange carriers, competitive local exchange carriers and wireless carriers.

**Table of Contents**