

Trinsic, Inc.
Form 10-K
April 15, 2005

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-K

(MARK ONE)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE
ACT OF 1934
FOR THE YEAR ENDED DECEMBER 31, 2004**

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

TRINSIC, INC.

(Exact name of Registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
incorporation or organization)

59-3501119
(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 No

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

Yes o No b

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 o.

The aggregate market value of the Registrant's Common Stock held by non-affiliates of the Registrant on June 30, 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 \$38,083,872.

The number of shares of the Registrant's Common Stock outstanding as of April 13, 2005 was approximately 55,313,302.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement relating to its 2005 Annual Meeting of Stockholders, to be filed subsequently, are incorporated by reference into Part III of this Report.

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ITEM 1. BUSINESS

GENERAL

Trinsic, Inc. (formerly Z-Tel Technologies, Inc.) and subsidiaries (Trinsic, we or us) is a provider of residential and business telecommunications services. We offer local and long distance telephone services in combination with enhanced communications features accessible through the telephone, the Internet and certain personal digital assistants. We recently began offering services utilizing Internet protocol, often referred to as IP telephony, voice over Internet protocol or VoIP. We provide services at both the retail and wholesale level.

At the retail level, we provide our traditional circuit-switched local services in forty-nine states, although our customers are primarily concentrated in six states. Our business VOIP offerings will be limited to the New York City metropolitan area and Tampa. Our facilities based residential services will be available in New York City. Excluding VoIP lines, we serve approximately 189,000 retail residential lines, 47,000 retail business lines, and 40,000 retail stand-alone long distance lines. We gained nearly all of the long distance customers with our acquisition of Touch 1 Communications, Inc. in April 2000. We serve approximately 1,600 VoIP lines.

We introduced our wholesales services during the first quarter of 2002. This service provides other companies with the opportunity to offer local, long-distance and enhanced telephone service to their own residential and business customers on a private label basis by utilizing our telephone exchange services, enhanced services platform, infrastructure and back-office operations. Sprint Communications Company (Sprint) has been our principal wholesale customer since February 2003. Previously, we had an agreement for wholesale services with MCIWORLD.COM (MCI), but that agreement was terminated in October 2003. At the wholesale level, we serve approximately 300,000 billable lines.

Historically we have utilized the unbundled network elements platform (UNE-P) as the primary basis of delivering our services to our retail customers and to the end users of our wholesale customers. Under UNE-P, we utilize various unbundled elements of the traditional local telephone companies (incumbent local exchange carriers or ILECs) to facilitate the delivery of our services to end users. Our access to ILEC networks has historically been based upon the Telecommunications Act of 1996 (the Telecommunications Act) which imposed a variety of duties upon the ILECs, including the duty to provide competitive local exchange carriers (CLECs), like us, with access to the individual components of their networks. Recent court decisions and rulings by the Federal Communications Commission (FCC), however, have sharply limited our rights to access the ILEC networks. FCC rules effective on March 11, 2005 eliminated mandatory national access to UNE-P for new customers and require us to transition our customers to alternative arrangements within one year unless we enter into commercial service agreements with

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ILECs that provide otherwise. See sections of this report entitled **Government Regulation** and **Risks Relating to Our Financial Condition and Our Business**. Our launch of VoIP services is designed to mitigate our reliance on access to certain ILEC network components.

In the normal course of business we have entered into interconnection agreements with ILECs that set forth the terms by which we gain access to their networks. These agreements are now subject to revision consistent with the FCC's recent UNE-P ruling. We have entered into an arrangement with Qwest that will allow us to continue utilizing UNE-P in its territories. We have also entered into an interim commercial services agreement with Verizon through May 31, 2005. We are discussing revised interconnection agreements and alternative commercial agreements with other ILECs as well. There can be no assurance that we will be successful in negotiating new interconnection agreements upon favorable terms.

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. 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.

We changed our name from Z-Tel Technologies, Inc. to Trinsic, Inc. on January 3, 2005.

SEGMENT FINANCIAL INFORMATION

For internal reporting purposes, we evaluate our business performance in terms of two segments: retail services and wholesale services. Financial information relating to both segments (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 23 **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 imposed 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 were 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. In 1996, the FCC, pursuant to the Telecommunications Act, 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 combined set of elements is referred to as the **unbundled network element platform** or **UNE-P**. Moreover, the FCC mandated that ILECs must provide the unbundled network element platform at rates based on a forward-looking, total long-run incremental cost methodology. Recent court decisions and FCC rulings have substantially reversed these earlier FCC mandates. (See sections entitled **Government Regulation** and **Risks Relating to Our Financial Condition and Our Business**.)

The Telecommunications Act also established procedures by which the regional Bell operating companies (**Bell operating companies**) were allowed to handle **in-region** long distance calls, that is, calls that originated from within their telephone service areas and terminated 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 could provide such in-region service if they demonstrated to the

FCC and state regulatory agencies that they 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 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

Within the retail segment, our principal services are traditional, circuit-switched local and long-distance telephone services for residences and businesses. We also recently launched VoIP-based services for residences and businesses.

Circuit-Switched Residential Services

Our local residential circuit-switched telephone service is typically bundled with long distance and a suite of our proprietary Internet-accessible and voice-activated functions called Trinsic Center. The enhanced features include voicemail, Find Me Notify Me, caller identification, call forwarding, three-way calling, call waiting, speed dialing and Personal Voice Assistant (PVA), which utilizes voice-recognition technology so that users can access secure, online address books from any phone using

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simple voice commands in order to send voice e-mails, find contact information and dial numbers, among other things. We offer various plans, including unlimited plans that include 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 our local services keep their existing phone numbers. We currently provide residential services in every state except Alaska, in areas served by a Bell operating company or Sprint and areas formerly served by GTE.

Our residential service includes unique features, all of which can be accessed and manipulated by telephone or Internet. Our proprietary voicemail enables 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. 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 residential services primarily through direct mail, telemarketers, joint marketing efforts with entities that have access to large numbers of consumers, independent sales contractors (including multi-level marketing companies) and referral programs. .

Circuit-Switched Business Services

Our local business circuit-switched business telephone service is targeted to small and medium sized businesses (typically having four or fewer lines) and businesses having multiple units. The service is local telephone service bundled with long distance (1+) telephone service, calling card services and enhanced features, including our proprietary features. Because we provide service in nearly every state, our business services are particularly valuable to firms having multiple locations in various states. With us, they deal with only one telephone company. We began offering business services in 2002. We provide service 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 our circuit-switched business telephone services primarily through our own in-house sales personnel and independent sale contractors.

Long Distance

We offer long distance services on a stand-alone basis to residences and business. Our stand-alone long-distance is a usage-based service that allows customers to use us as their primary long distance calling provider to complete their direct-dialed long distance (1+) calls. We do not actively market the long distance services. We gained nearly all of the long distance customers with our acquisition of Touch 1 Communications, Inc. in April 2000.

VoIP Services

We offer VoIP telephone services in areas within reach of our own IP telephony network. Our VoIP network utilizes Cisco technology and services and is integrated with our enhanced communications services platform so that in addition to increased bandwidth and service flexibility, our customers enjoy features such as PVA, our voice-activated

virtual address book. The services are offered to both residences and businesses. Our facilities based residential services will be available in New York City and our business VOIP offerings will be limited to the New York City metropolitan area and Tampa. We plan to expand out IP telephony network to additional cities as resources permit.

We market and sell our residential VoIP services primarily through direct mail and independent sales contractors. We market and sell our business VoIP services primarily through our own in-house sales personnel.

Billing and Collection

We have three primary methods for billing and collecting from our retail customers. For our residential 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 retail customers by mail and receive payment through checks delivered by mail.

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WHOLESALE SERVICES

Within the wholesale segment, 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, enhanced 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.

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 sole wholesale services customer.

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 principal method of delivering services to our customers 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 reduce costs and increase accuracy. Provisioning is the process by which we (or our wholesale customers) are established as the customer'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 -

Re-focus our marketing resources on the Northeastern United States where we have a dense existing consumer customer base and an IP telephony network successfully deployed;

Continue to build out our IP telephony network in the Northeast to compliment our existing network and customer density there as resources permit;

Continue to migrate customers to our own network as resources and the terms of our agreements allow; and

Continue to add multi-line business customers directly to our IP telephony network.

GOVERNMENT REGULATION

Overview and Current Regulatory Developments

The Telecommunications Act of 1996 (the Telecommunications Act), signed into law on February 8, 1996, comprehensively amended the Communications Act of 1934 (the Communications Act) and effected changes in regulation at both the federal and state levels that impact nearly every segment of the telecommunications industry. The stated purpose of the Telecommunications Act is to promote competition in all areas of telecommunications.

Some of our services are regulated and some are not. In providing our non-common carrier services such as Personal Voice Assistant, 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, and as an enhanced service provider, as that term is defined in the rules of the Federal Communications Commission (FCC). These operations currently are not regulated by the FCC or the states in which we operate. In providing residential and business telecommunications 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. Certain aspects of our voice over Internet protocol (VoIP) services (also called IP telephony services) may or may not be subject to common carrier regulation. The regulatory classification of these services is currently subject to a number of regulatory proceedings before state regulatory commissions, the FCC, and the courts. However, unlike many of our VoIP competitors, we are certified as a facilities-based competitive local exchange carrier in forty-nine states and the District of Columbia. We believe our

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certification as a common carrier gives us the flexibility to operate and offer our advanced IP telephony services regardless of the final regulatory classification of those services.

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. (As discussed below, the FCC has ruled that VoIP services in certain instances are inherently interstate and therefore subject to federal regulation, and not state level regulation.) 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 and fees on telecommunications carriers and regulate construction activities involving public rights-of-way. Changes to the regulations imposed by any of these regulatory authorities 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 this 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.

FEDERAL REGULATION

FCC Policy on Unbundled Access to Network Elements of Incumbent Local Exchange Carriers

While Trinsic's regulatory environment continues to be dynamic and complex, there is one overriding issue that drives our business: our ability to interconnect with, access and use the local networks of incumbent local telephone exchange carriers (like Verizon, SBC, BellSouth and Qwest) to provide our services. The incumbent local exchange carrier or ILEC is the old established wireline telephone company. Non-incumbent telephone companies like us are referred to as competitive local exchange carriers or CLECs. All of our telecommunications services, residential and business, analog and VoIP, utilize, to some extent, an ILEC network.

- § Our residential and business local telephone services throughout the United States predominantly utilize the unbundled network element platform (or UNE-P) which is a combination of functions and components of an ILEC network, including analog loops, switching and transport. As discussed below, FCC rules effective on March 11, 2005 restricted our access to UNE-P for new customers and are requiring us to transition our customers to alternative commercial arrangements, different networks or resale.
- § As an alternative to utilizing UNE-P, in New York City and in Tampa, Florida, we have begun to provide VoIP residential and business telephone services through a network architecture called UNE loop, or UNE-L. The UNE-L entry strategy requires us to establish collocation arrangements with the ILEC and have unbundled access to analog loops, and transport.

§

We provide VoIP telephony services to businesses in the New York City metropolitan area and Tampa utilizing a next-generation IP network. This network requires us to purchase or lease high-capacity digital connections from the customer's premises to our next-generation IP facilities. In many instances, the only cost-effective means of obtaining that high-capacity digital connection is from the ILEC. Typically, we provide service by means of a combination of unbundled high-capacity loops and transport, which is called an Enhanced Extended Link, or EEL. In some situations, we obtain transport from another, non-incumbent provider but are dependent upon the ILEC for the final, last-mile connection to the customer premises. In those situations, we purchase an unbundled high-capacity loop from the ILEC. In the absence of access to unbundled access to high-capacity loops and transport, our only option would be to purchase these connections as retail, special access circuits that are available from ILECs and other providers. The prices of these retail (and largely-deregulated) special access circuits are, in many instances, substantially higher than the wholesale (and regulated) prices for unbundled network elements.

Recent court decisions and FCC rulings have sharply limited our ability to utilize the networks of incumbent local telephone companies to provide our services, requiring us to adjust our business plan accordingly.

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On December 15, 2004, the FCC limited the availability of unbundled network elements pursuant to section 251 of the Telecommunications Act of 1996 that Trinsic utilized to provide services to our customers in the *Triennial Review Remand Order, Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, WC Docket No. 04-313, CC Docket No. 01-338, FCC 04-290 (rel. Feb. 4, 2005). The FCC ruled that ILECs are no longer required to provide Trinsic and other entrants access to unbundled analog switching—a key component of the unbundled network element platform combination of elements, which is how we provide services to the vast majority of our customers. This FCC *Triennial Review Remand Order* also limited our ability to access unbundled high-capacity loops and dedicated transport in many urban and suburban locations.

The FCC *Triennial Review Remand Order* became effective March 11, 2005. After that date, we are unable to place orders for new customers and lines that utilized unbundled switching and high-capacity loops and transport that no longer qualified for unbundling under the new rules. For Trinsic's embedded base of customers, the FCC imposed price increase of \$1 per month for each line that utilized unbundled switching and a price increase of 15% for each high-capacity loop or transport arrangement that no longer qualified for unbundling under the new rules. The FCC *Triennial Review Remand Order* also established a one-year transition period for this embedded base of customers at the end of that transition period, currently set as March 15, 2006, the prices for access to unbundled switching and those loop and transport arrangements will no longer be federally regulated.

In the normal course of our business, we enter into contractual arrangements with ILECs for access to their networks. We are currently in negotiations to establish new contractual arrangements with ILECs for both our embedded base and future customers. We have already executed one such commercial arrangement with Qwest, which covers Qwest territories in Washington, Oregon, Arizona, Colorado, New Mexico, Idaho, Montana, North Dakota, South Dakota, Iowa, and Nebraska. We are currently in discussions with Verizon, SBC and BellSouth over changes to interconnection agreements that may be required by the FCC *Triennial Review Remand Order*.

CLECs, states, and ILECs have filed appeals of the *Triennial Review Remand Order*. ILECs have filed an appeal before the D.C. Circuit Court, *United States Telecom Ass'n et al. v. FCC*, No. 05-1058, and have asked that the D.C. Circuit stay a portion of the *Triennial Review Remand Order* that permits competitors to convert essentially deregulated special access circuits to regulated, unbundled high-cap loop and transport circuits in certain circumstances. CLECs and states filed appeals before several circuit courts and those appeals were consolidated before the Third Circuit Court of Appeals in Philadelphia. The third circuit court of appeals has subsequently transferred these appeals to DC circuit court. Briefs in that appeal have not been filed and we cannot anticipate whether the outcome of those appeals will improve or decrease our options in providing service to our customers.

The FCC's *Triennial Review Remand Order* is the result of years of litigation over the terms and conditions on which Trinsic and other competitors may provide service utilizing the networks of incumbent local exchange carriers. In 2003, the FCC ruled that entrants like Trinsic would be able to purchase analog switching, dedicated transport and high-capacity loops 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 switching and transport rules be vacated after sixty days or upon denial of a petition for rehearing, whichever was later. In June 2004, the FCC and the U.S. Department of Justice declined to appeal this decision to the United States Supreme Court, and the Petition for Writ of Certiorari filed by Trinsic (then Z-Tel) and other companies before the United States Supreme Court was denied. The FCC issued interim rules and immediately began work on formulating the final unbundled network access rules that appear in the *Triennial Review Remand Order*.

Court consideration of the unbundled access rules followed a parallel track. The FCC first established network element unbundling rules in its August 1996 *Local Competition Order* in CC Docket No. 96-98. Those rules were appealed to the Eighth Circuit Court of Appeals and later to the U.S. Supreme Court. In its January 25, 1999 *AT&T v. Iowa Utilities Board* ruling, the Supreme Court remanded the network unbundling rules 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 for end-users with four or more voice grade (DSO) equivalents or lines, provided that the incumbent local

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exchange carrier provides nondiscriminatory access to combinations of unbundled loops and transport (also known as the Enhanced Extended Link or EEL) throughout Density Zone 1, and the incumbent local exchange carrier's local circuit switches are located in (i) the top 50 Metropolitan Statistical Areas as set forth in Appendix B of the Third Report and Order and Fourth Further Notice of Proposed Rulemaking in CC Docket No. 96-98, and (ii) in Density Zone 1, as defined in the FCC's rules. 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*.

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 Supreme Court denied the competitors' request for an appeal.

In August 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 transport, packet switching, line-sharing for DSL services, and fiber-fed next-generation digital loop carrier loops. In subsequent decisions, the FCC has even more sharply limited the ability of companies like Trinsic to obtain unbundled access to ILEC fiber optic lines. On August 9, 2004, in a reconsideration order in CC Docket No. 01-338, the FCC ruled that ILECs need not be required to unbundled fiber to multiple dwelling units, even if fiber only reaches the minimum point of entry of the building. On October 18, 2004, in a second reconsideration order in CC Docket No. 01-338, the FCC ruled that fiber-to-the-curb loops will also be exempt from unbundling requirements just as fiber-to-the-premises loops were exempted in the August 2003 order. The FCC also clarified that ILECs were not required to add time-division multiplexing capabilities to any new packetized transmission facilities constructed in order to facilitate interconnection by competitors.

These restrictions on access to ILEC fiber networks and next-generation architecture could have a significant impact on our ability to provide services to our customers. In particular, even in situations in which Trinsic would otherwise be entitled to unbundled access to a loop, transport circuit or EEL, these exclusions could permit ILECs to refuse to offer these connections to us, on the basis that loop, transport or EELs qualifies as fiber-to-the-premises, or fiber-to-the-curb, or involves access to packet switching. As a result, these exclusions from unbundling could limit our ability to provide service to customers cost-effectively and could have a significant and material impact upon our business.

The regulatory uncertainty and the absence of effective network access rules have required us to adjust our business plan in a number of ways, as discussed elsewhere in this report. For example, we are attempting to migrate portions of our UNE-P customer base in New York City to our own network, which uses an architecture called UNE-L. In other markets, we have rolled-out of our next-generation VoIP network, which depends in part on unbundled access to high-capacity loops. As a result, these regulatory developments have had an immediate, significant, adverse and material impact upon our business. We are in discussions with ILECs to establish commercial terms and arrangements for access to their local networks, but we have only been successful in doing so with Qwest. There is no assurance that we will be able to reach similar commercial arrangements with Verizon, SBC, BellSouth or other ILECs. Moreover, even if we enter into such commercial arrangements, the terms of those arrangements might require us to adjust our business plan and service offerings significantly. We may be required by these regulatory developments to limit access to our service, withdraw from certain markets, alter our negotiation strategy and potentially arbitrate these agreements. Arbitration would likely take some time and could result in uncertainty as to our legal rights in the interim. It is also possible that during the pendency of these negotiations, one or more incumbent local telephone company suppliers may refuse to abide by the terms of the existing agreements or act terminate those agreements outright. Trinsic is currently evaluating all of its legal options to ensure that we can continue to meet the needs of our existing and future customers.

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Pricing of Unbundled Network Elements

Even in situations where we retain the right to unbundled access under the new FCC rules (for example, analog loops and high-capacity loops and transport in many instances), the regulated pricing of those network elements is subject to change.

The FCC issued its first interconnection order on August 8, 1996 and in that *Local Competition Order*, the FCC established the pricing methodology for unbundled network elements. That methodology was Total Element Long-Run Incremental Cost, or TELRIC. Incumbent local telephone companies and state commissions appealed the FCC's 1996 *Local Competition Order* to the United States Court of Appeals for the Eighth Circuit. 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.

The Supreme Court in 1999 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 subsequently upheld the FCC's TELRIC rules, which use 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, in *Verizon v. FCC*, the Supreme Court upheld the FCC's TELRIC pricing rules.

Although the FCC's TELRIC rules have been supported by the courts, the establishment of rates occurs on a state-by-state basis and is subject to change. Some states are currently re-evaluating the pricing of these unbundled network elements. As a result, it is possible that prices in some states could increase or lower rates over existing levels. 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.

Despite the fact that the TELRIC rules have been supported by the courts, the FCC is currently reevaluating several of these rules, by means of a rulemaking notice issued in September 2003 in WC Docket No. 03-173. The 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; for other elements, such a modification could result in lower rates. 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. The FCC rulemaking is still pending, and changes to the FCC's TELRIC rules could significantly alter the prices we pay for unbundled access to ILEC network elements. 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.

The Rights and Obligations Common Carriers Under Federal Law

We are certified as a local exchange common carrier in forty-nine states and the District of Columbia. The Communications Act, as amended by the Telecommunications Act, imposes a number of regulatory requirements on common carriers generally and local exchange carriers specifically. There is currently significant regulatory uncertainty as to whether certain new enhanced services such as VoIP-based telephone services must be subject to common carrier regulation. We believe that having our common carrier licenses gives us the flexibility to provide our customers a broad array of services and does not make our service offerings dependent upon any one particular regulatory classification.

In addition, our status as a common carrier gives us rights under section 251 of the Telecommunications Act to interconnect with, obtain access to, and collocate on the premises of incumbent local exchange carriers like Verizon, SBC, BellSouth, and Qwest. Section 251 of the Act requires ILECs to

provide physical collocation to other common carriers, which allows companies such as us and other competitive local

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exchange carriers to install and maintain our own network termination equipment in incumbent local exchange carrier central offices or, if requested or if physical collocation is demonstrated to be technically infeasible, virtual collocation;

offer components of their local service networks on an unbundled basis to other common carriers so that other providers of local service can use these elements in their networks to provide a wide range of local services to customers (*See FCC Policy on Unbundled Access*, above); and

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

Companies that are not common carriers do not have the section 251 rights described above. In addition, all local exchange carriers must

interconnect with the facilities of other common 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. FCC implementation of those provisions of the Telecommunications Act has been the subject of ongoing litigation that continues to this day. The most contentious litigation has centered around FCC and state rules regarding the rates, terms and conditions of unbundled network access, and the current status of those rules is discussed above (*FCC Policy on Unbundled Access* and *Pricing of Unbundled Network Elements*)

The rights and obligations of common carriers under federal law impact our business, as do other pending FCC proceedings. The subsections that follow outline a number of these areas. These and many other issues remain subject to further consideration by the courts and the FCC. We cannot predict the ultimate disposition of any of these and other matters.

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 any of these and other matters.

Regulation of Rates, Terms and Conditions of Interstate Service

With regard to the FCC, Trinsic is classified by the FCC as a non-dominant provider of interstate telecommunications services. In general, the FCC does not regulate the rates, services, and market entry 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. 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 to provide certain interstate services; however, the FCC has implemented a process that generally permits a non-dominant, competitive company to discontinue such interstate services on an expedited basis.

We are entitled to file tariffs for the termination of interstate traffic by other carriers to our customers, and those tariffs are subject to certain FCC regulation (*See* Interstate Tariffs and Rates, below).

Interconnection Agreements

The rights and obligations Trinsic has pursuant to section 251 and 271 of the Telecommunications Act are generally implemented through interconnection agreements with ILECs through which we obtain access to the ILEC networks. Section 252 of the Telecommunications Act requires local exchange carriers to negotiate with us in good faith to enter into interconnection agreements and contains a specific process for negotiating and arbitrating interconnection agreements with incumbent local

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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.

In the normal course of business, we have entered into interconnection agreements with the ILECs in all states where we currently offer local exchange services. To implement the *Triennial Review Remand Order* and to ensure that we obtain interconnection and unbundled access, we are reviewing available contracts or negotiating new contracts in a number of states. However, at any point in time an 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. The terms of those contracts provide for the agreements to continue in place until a replacement is executed or upon termination by either party.

A 2004 FCC decision has a direct impact on the interconnection agreement negotiation and arbitration process. On July 13, 2004, the FCC released a Report and Order in WC Docket No. 01-338 and CC Docket No. 96-98 that substantially and significantly curtailed the Pick-and-Choose rule that applied to Section 251 interconnection agreements. Section 252(i) of the Act requires that ILECs permit CLECs like Trinsic the ability to opt in to any interconnection and network access arrangements that an ILEC offers to another CLEC in an approved Section 251 agreement. This process is important to ensuring that ILECs do not discriminate between CLECs in the terms of interconnection and network access. Trinsic has utilized this pick-and-choose process to obtain interconnection agreements with ILECs in many of the states in which we do business. The Supreme Court in the *Verizon* decision supported the FCC's original pick-and-choose rule as being consistent with the nondiscriminatory access purpose of the 1996 Act. The FCC's July 2004 Order significantly changes this process and drops the pick-and-choose requirement with an all-or-nothing approach. This rule requires that Trinsic, in order to avail itself of a particular rate, term, or condition of interconnection or access that an ILEC is offering another CLEC, must adopt the ILEC-CLEC contract in its entirety, rather than simply the specific term of interconnection or access. Trinsic opposed this proposal before the FCC and we believe that it is inconsistent with the plain language of section 252(i) of the Act. The rule has the potential to make it more difficult for Z-Tel to obtain interconnection agreements suitable to our business and opens up the possibility that another CLEC may obtain better terms of interconnection or access from an ILEC on an important service or element than Trinsic because other provisions of the ILEC-CLEC agreement (such as arrangements on other network elements) may be unsuitable or unworkable for Trinsic. Implementation of the FCC rule in a manner that increases our cost of obtaining interconnection agreements or results in discrimination could significantly and adversely impact Trinsic's business.

The ability of a CLEC like Trinsic 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, litigating enforcement of interconnection agreements in state or federal courts in the Eleventh Circuit and elsewhere could substantially increase the cost of such litigation. 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 ILECs that we deem unacceptable.

Collocation

The FCC has adopted rules designed to make it easier and less expensive for competitive local exchange carriers to collocate 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 collocated and requiring incumbent local exchange carriers to offer alternative collocation arrangements, such as cageless collocation. Restrictions and impediments to collocation could harm our business, as we collocate in ILEC central offices to provide both our UNE-L network services and our next-generation network VoIP services.

The FCC's collocation rules have been subject to a number of legal challenges by incumbent local telephone companies. On June 18, 2002, the D.C. Circuit affirmed the legality of the FCC's collocation rules in *Verizon Telephone Companies v. FCC*. In the process of these court challenges, the FCC was required to modify its rules in a way that could increase the cost and time for competitors to collocate equipment and could have a substantial and material impact on Trinsic's future network deployment.

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Line Sharing, Line Splitting, and Dialtone-DSL Tying

In the *Triennial Review Order*, the FCC eliminated its rules that required ILECs to facilitate line-sharing arrangements. Line-sharing permits a competitive carrier to obtain unbundled access to the high-frequency portion of a loop in order to provide DSL on that loop while the ILEC continues to provide analog dialtone service over the low frequencies. Line-splitting is an alternative arrangement that permits one competitive carrier to provide DSL service over the high-frequency portion of an ILEC's loop while another competitive carrier provides analog dialtone service over the ILEC's loop. FCC rules adopted in 1999 (for line-sharing) and 2001 (for line-splitting) required ILECs to offer to facilitate these arrangements on an unbundled basis. The FCC eliminated these requirements in the 2003 *Triennial Review Order*. The elimination of the line-sharing rules could harm Trinsic's business. If a customer chooses to purchase DSL from the ILEC, Trinsic's ability to provide voice services over that facility will be limited.

Many ILECs, including BellSouth, Verizon and SBC, require their DSL customers to purchase analog dialtone service from them as well. Those policies limit the market for VoIP services that utilize broadband, DSL connections to provide dialtone service, as DSL customers will have already purchased dialtone from the ILEC. The FCC is also considering a petition filed by BellSouth that would preempt state orders in Kentucky, Georgia and Louisiana that order BellSouth to stop requiring its DSL customers to purchase analog dialtone service from BellSouth. Trinsic and other entrants have opposed BellSouth's efforts to tie the sale of DSL to analog dialtone service on the basis that such a policy has an unreasonable and unlawful effect of suppressing competition for next-generation, VoIP services. Other ILECs, like Qwest and Verizon, do not have such a policy. The FCC has not yet ruled on the BellSouth petition.

Bell Operating Company Entry into the Long Distance Market.

The Telecommunications Act permitted the Bell operating companies (Verizon, SBC, Qwest, and BellSouth) 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. Bell operating companies have received long-distance authority in all 50 states.

With Bell operating companies authorized to provide long-distance service nationwide, it is generally expected that competition for Trinsic'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 Trinsic'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 that Bell companies must comply with, 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. The *Triennial Review Remand Order* issued earlier this year did not directly address the question of a Bell company's statutory obligation under section 271 of the Act to provide access to the network elements specifically-enumerated in section 271, particularly with regard to checklist item six, switching, even if those network elements are not required to be unbundled pursuant to section 251. However, last fall, the FCC ruled that with regard to the broadband network elements that it did not require to be unbundled under section 251 in the 2003 *Triennial Review Order*, the FCC ruled that Bell companies are not required to offer access to broadband elements pursuant to section 271 absent a 251 unbundling requirement. Trinsic disagrees with that FCC ruling. All of the Bell companies have currently pending before the FCC petitions requesting that the FCC forbear from these

independent section 271 regulatory requirements. Trinsic has vigorously opposed those petitions. Trinsic will vigorously enforce its rights to access to Bell company networks pursuant to the independent legal authority that the section 271 checklist requires. If the FCC, state commissions or the courts do not enforce section 271 checklist items as separate obligations on Bell companies, our ability to provide service to our customers and our business would be harmed.

Universal Service Contributions.

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. 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 assesses funds owed based on a providers interstate revenue and the FCC adjusts payment requirements and

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levels quarterly. 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 the FCC and individual states in the future.

On July 30, 1999, in *Texas Office of Public Utility Counsel v. FCC*, the Fifth Circuit overturned many of the FCC's universal service collection rules. In October 1999, on remand from that decision, the FCC issued new collection rules which stated that if a carrier derives less than 8 percent of its revenue from interstate services, its international revenues will not be used in calculating the contribution. For carriers receiving 8 percent or more of their revenues from interstate services (as Trinsic does), the FCC stated that it will include international revenues in the base for determining collections. This and other changes to the universal service program could affect our costs by increasing charges for interstate access or requiring higher assessments on interstate revenues. On May 20, 2001, the Fifth Circuit once again reversed the FCC's rules and decided, in *Comsat Corp. v. FCC*, that the FCC cannot permit local exchange carriers to recover universal service charges through access charges, as such an arrangement would create an implicit subsidy.

In 2002, the FCC modified the method in which carriers are required to make payments into the fund. Among other changes, the FCC announced that carriers are to make payments based upon projected, collected end-user interstate revenues (as opposed to historical, gross-billed revenues, as the FCC had previously used). Competitive carriers are also prohibited from marking-up USF contributions for administrative fees if carriers recover universal service contributions through phone bill line items. These measures impact the manner in which we make contributions into the federal universal service fund and could impact our business. The FCC is currently studying proposals to increase services for which the universal service fund would support, which could increase the size of the fund significantly and subsequently increase our financial obligation to the fund. The FCC is also examining its rules relating to the designation of Eligible Telecommunications Carriers that are eligible to receive payments from the fund. The outcome of these proceedings and subsequent litigation could adversely impact or delay our ability to obtain universal service funding for our services if we seek it, and may also increase the sums we pay into federal or state universal service funds, increase the price for access, and harm our ability to compete with carriers that do obtain such funding. Changes to federal or state universal service support programs 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 Trinsic make its long-distance service information directly available to customers pursuant to private contracts. In March 1999, the FCC adopted rules that require interexchange carriers like Trinsic to make specific disclosures on their web sites of their rates, terms and conditions for domestic interstate services. These detariffing and disclosure requirements could increase our costs in providing interstate long-distance services to our customers.

The FCC effectively regulates the rates Trinsic and other competitive carriers may charge to terminate long-distance calls from other providers known as interstate terminating switched access. The April 27, 2001 Report and Order in CC Docket No. 96-262 provided for a four-year transition for Trinsic's and other competitive carrier's terminating access rates, which completed on June 20, 2004. As of that date, Trinsic's interstate terminating switched access rate tariffed before the FCC can be no higher than the competing ILEC in any particular area. Trinsic maintains a switched access tariff with the FCC that it believes meets these requirements. However, as ILEC switched access rates change, Trinsic may be obligated to change its tariff similarly. The result could be lost revenues from interstate terminating access and administrative costs of compliance.

In the past, Z-Tel/Trinsic has had disputes with interexchange carriers over nonpayment of terminating access charges owed to us. We have settled many of these disputes. However, there is a risk of nonpayment and bad debt with regard to nonpayment. In the past, Trinsic has adamantly litigated and defended its position, but nonpayment or default could have a substantial and material adverse impact on our business.

Numbering and Number Portability.

The FCC has issued rules that permit a customer to keep its telephone number and transfer it among carriers. In 1996, the FCC released rules requiring all local exchange carriers to have the capability to permit both residential and business customers to retain their telephone numbers when switching from one local service provider to another, known as number portability. In 2004, those rules were extended to wireless customers and require that Trinsic and other carriers permit customers to port their landline telephone number to wireless customers. 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. 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.

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The FCC and state commissions also regulate the availability and assignment of telephone numbers and area codes. Before the 1996 Telecommunications Act, the Bell operating companies and other ILECs controlled a number of these tasks. In August 1997, the FCC issued rules transferring responsibility for administering and assigning local telephone numbers from the Bells and ILECs to an independent, neutral entity. In 1996, the FCC issued new numbering regulations that prohibit states from creating new area codes in a manner that would unfairly hinder competitive local exchange carriers by requiring that their customers use 10-digit dialing while ILEC customers need only use 7-digit dialing. Each carrier is required to contribute to the cost of numbering administration through a formula based on end-user telecommunications revenues.

In May 1999, the FCC initiated a proceeding to address the problem of the declining availability of area codes and phone numbers. In December 2000, the FCC issued a Further Notice of Proposed Rulemaking in CC Dockets Nos. 96-98 and 99-200 that proposed adoption of a market based approach of optimizing number resources, which would involve the introduction of charges for allocation of number resources. If a market-based approach to number allocation is introduced, as the FCC proposed, it could result in added administrative expenses for us and possibly make it more difficult or costly for us to obtain telephone numbers for our customers.

Restrictions on Bundling. On March 30, 2001, in CC Dockets Nos. 96-61 and 98-183, the FCC eliminated a rule that prohibited all carriers from bundling customer premises equipment and telecommunications services. 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 also applies its slamming rules (which originally covered only long distance) to local service as well. Trinsic 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 handling of CPNI could result in significant administrative expense to Trinsic in modifying internal customer systems to meet these requirements.

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 Service, 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 over its Next-Generation Network. 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 E911 services may be different for dialtone-like services as opposed to 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

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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. A panoply of 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 collocate equipment and purchase unbundled network elements from incumbent local telephone companies pursuant to section 251 of the 1996 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 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. On April 21, 2004, the FCC determined that certain of AT&T's long-distance services that utilize IP technology were to be regulated as a telecommunications service because AT&T's use of IP technology did not change the form or content of the long-distance communication and therefore meet the statutory definition of information service. The FCC was careful to state in both the Pulver.com and AT&T IP Telephony decisions that in so ruling, it was reserving its right to come to a different outcome in the IP-Enabled Services rulemaking proceeding. On November 12, 2004, in WC Docket No. 03-211, the FCC ruled that Vonage's DigitalVoice service, a Voice over IP application, was inherently interstate; as a result, the FCC preempted an attempt by the Minnesota regulator to impose traditional telephone company regulations, including certification requirements, on that service.

These FCC decisions and proposals indicate the state of regulatory flux that industry participants face, and it is impossible to forecast the final outcome of these regulatory classification decisions. We believe that many of the services we provide, including Personal Voice Assistant and features and functions 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 of regulation applicable to common carrier telecommunications services. If that happens, those services would become subject to FCC regulation, and the impact of that reclassification is difficult to predict. Unlike many VoIP and information service providers, Trinsic maintains common carrier certificates in the states in which we do business; as a result, we are positioned to comply with state or federal rulings that would declare any or part of these services to be regulated common carrier services.

Certain of Trinsic's IP telephony 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. 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 Trinsic would not be able to offer because Trinsic 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 inexorably make it difficult, more costly, or even impossible, for Trinsic to provide its current telecommunications and information services to consumers.

In addition, several ILECs, including BellSouth and SBC, have filed petitions before the FCC requesting that the FCC forbear from long-standing network access requirements for their networks to the extent those networks are capable of supporting IP services. These petitions would remove ILEC broadband networks from the *Computer II/III* rules that give competitors the

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ability to interconnect with these networks. Similarly, on February 13, 2003, the FCC proposed in CC Docket No. 02-42 that incumbent local exchange carrier provision of wireline broadband Internet access services as an information service and regulate the provision of such services pursuant to Title I of the Communications Act of 1934. In addition, the FCC sought comment on whether its *Computer II/Computer III* rules, which govern access to ILEC 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 Trinsic's ability to provide services to its customers.

Intercarrier Compensation (Interstate Access Charges and Reciprocal Compensation)

Because Trinsic, as a competitive local exchange carrier, passes and receives local and long distance 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.

On March 3, 2005, the FCC, in WC Docket No. 01-92, issued a Further Notice of Proposed Rulemaking that called for reform of the current intercarrier compensation regime. Under current rules, the rate for the exchange of traffic depends on (1) the type of traffic, (2) the types of carriers involved and (3) the end points of the communication. The FCC found that those disparities presented opportunities for regulatory arbitrage, and the FCC presented several proposals made by industry participants and the states.

The 2005 FCC proposal reaches no tentative conclusion as to the proper intercarrier rate, an approach that differs from the FCC's prior position on this topic. In April 2001, the FCC released a Notice of Proposed Rulemaking in the same docket as the March 2005 notice (CC Docket No. 01-92), and in that document the FCC proposed that carriers transport and terminate traffic between one another on a bill-and-keep basis, rather than per-minute reciprocal compensation charges. Because Trinsic 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 final determination in CC Docket No. 01-92 may have upon our business.

The current intercarrier compensation regime is subject to dispute and litigation on a number of fronts. In particular, FCC rules relating to compensation for dial-up calls to Internet service providers have been reversed by the D.C. Circuit Court of Appeals twice, with no final resolution. The FCC is under an obligation to report on its progress for these rules before the D.C. Circuit periodically. We cannot predict the effect that the FCC's resolution of these issues will have on our business.

FCC decisions relating to intercarrier compensation have a significant impact upon industry structure and economics. Since passage of the Telecommunications Act of 1996, the FCC has twice 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.

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 (See *Interstate Tariffs and Rates* above). Changes to the intercarrier compensation regime could affect our costs and revenues and could also impact the competitive environment for telecommunications and information services.

Potential Federal 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. In 2004, Representative Chip Pickering and Senator John Sununu both introduced legislation that would determine that services that utilized the Internet Protocol would not be subject to state and local regulation. Both of those bills have had hearings before respective committees in the House and Senate. Senator Sununu's bill passed the Senate Commerce Committee. Neither bill has been submitted to the full chamber for consideration and a vote. While similar, these bills differ in how issues such as access charges and universal service

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obligations would apply to services that utilize the Internet Protocol. It is difficult to determine the long-run impact either of these bills if they were to become law would have upon our business.

Other Issues

There are a number of other federal regulatory issues and proceedings that could have an effect on our business in the future, including the fact that

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 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 Do-Not-Call-Rules that limit the ability of telemarketers to make telephone calls to consumers that choose to be listed on the national Do-Not-Call-Registry. These rules could make future telemarketing efforts more expensive and less effective.

In 1999, the FCC has adopted rules designed to make it easier for customers to understand the bills of telecommunications carriers. These Truth-in-Billing Rules, CC Docket No. 98-170, establish certain requirements regarding the formatting of bills and the information that must be included on bills. In 2000, the FCC modified its Truth-in-Billing rules to clarify that where an entity bundles a number of services, some of which might be provided by different carriers, as a single package, that offering can be listed on a bill as a single offering. On March 30, 2004, NASUCA, an organization of state consumer advocates, filed a petition before the FCC asking for more-stringent regulation of bill format, which the FCC is considering in WC Docket No. 04-208. Changes in these FCC rules could increase our costs of doing business significantly and could make it more difficult to assess and collect regulatory and other fees that, as a common carrier, we are obligated to pay to local, state and federal entities.

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. 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.

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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.

Trinsic's rates for intrastate switched access services, which Trinsic 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 Trinsic'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 Trinsic'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, pricing and terms and con