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Timothy M. Boucher
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Spirit of Service™

VIA ECFS

EX PARTE

January 22, 2007

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: *In the Matter of Petition of Qwest Communications International Inc. for Forbearance from Enforcement of the Commission's Dominant Carrier Rules As They Apply After Section 272 Sunset Pursuant To 47 U.S.C. § 160*, WC Docket No. 05-333

Dear Ms. Dortch:

Qwest Communications International Inc. ("Qwest") hereby files the following clarifications in connection with its forbearance petition in the above-captioned proceeding:

First, Qwest clarifies that it currently provides international interexchange ("IX") telecommunications services to business and residential customers located in-region through its Section 272 affiliates. Qwest believes that the data it has submitted on competition amply demonstrate that it lacks market power in the provision of both domestic interstate and international in-region IX services. Qwest also notes that the Qwest family of companies includes certain foreign affiliates that are engaged in the provision of international telecommunications services on particular routes between the United States and foreign countries. However, Qwest is not affiliated with any foreign carrier that is a monopoly provider of telecommunications services in a relevant market in any destination country. Moreover, Qwest's foreign affiliates provide international transport services that represent a small share of the foreign end of any relevant routes. Further, Qwest's foreign affiliates do not provide local access service in any foreign country. Rather, they purchase a small amount of local access, as needed, from unaffiliated local access providers in each foreign country. Accordingly, Qwest is presently classified as a non-dominant provider of international telecommunications services under Section 63.10 of the Federal Communications Commission's rules and Qwest believes nothing will change with respect to this status under Rule 63.10 in the event Qwest ceases to operate its present Section 272 affiliates in full Section 272 compliance or integrates those entities into the operating company.[1]

Second, Qwest previously has filed information in this proceeding showing that it does not possess market power in the provision of telecommunications services to large enterprise customers. Qwest herewith provides additional evidence showing that it does not have market power in the provision of telecommunications services with respect to one subset of that customer segment, enterprise customers, located either within or outside of Qwest's region, that have multiple locations. Indeed, as indicated by the attached 2003 and 2006 reports prepared by Lehman Brothers (Appendices 1 and 2, respectively), there are two leading providers of telecommunications services to such customers on a nationwide basis and Qwest is not one of them. Rather, these data demonstrate that Qwest is significantly smaller and accounts for a very small share of the revenues paid by these enterprise customers (*i.e.* in the magnitude of 5%). Qwest submits these data, among other things, in further response to Staff Information Request No. 4 contained in a letter dated January 5, 2007 from Thomas J. Navin to Craig J. Brown.

Respectfully submitted,

/s/ Timothy M. Boucher

Appendices

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[1] *See* 47 C.F.R. § 63.10.

APPENDIX 1

November 11, 2003

United States of America
Telecommunications
Enterprise Telecom Serivces

Enterprise Telecom Serivces

Initiation of Coverage

Enterprise Telecom; A Comeback Begins

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Sector View:

New: 2-Neutral

Old: 2-Neutral

Investment conclusion

- We initiate coverage of Enterprise Telecom Services and are optimistic regarding the industry's financial and operational streamlining, the consolidation that has occurred to date (and more to come), and cautiously optimistic regarding improving demand and pricing over the next year.

Summary

- We expect a cyclical up-tick, improving operational efficiencies, and industry consolidation to drive stabilizing revenues, improving margins and 10% EBITDA growth in 2004 for the commercial units of our covered Enterprise Carriers.
- We favor Carriers with greater high-end Enterprise exposure, particularly wholesale, and less SME. While competition remains intense across Enterprise telecom, we believe it is poised to improve in 2004 within the wholesale segment, while it is likely to intensify within SME.
- We believe the supply/demand imbalance has finally begun to stabilize. On the supply side, due to recent consolidation and selected bidder-ineligibility among the financially weaker carriers, we believe the bidding-group on a given contract has been reduced by almost 50% from '01's 8-10 bidders. On the demand side, we are seeing the early signs of improvement in key employment, technology sales (chips), and a proprietary Lehman Brothers Fortune 500 Survey.
- Enterprise coverage group valuations hover near 10-year lows - LVLT is our top recovery pick, while T is our best value pick.

Enterprise Telecom Services Launch:

We initiate specialized coverage of the Enterprise Telecom Services sub-sector of the US Wireline Telecom Services market, with an emphasis on carriers specializing in the high-end of the market (Wholesale/Large Enterprise), companies designated as “Enterprise Carriers”. We are optimistic regarding the industry’s financial and operational streamlining, outlook for 2004 revenue stabilization, margin improvement and EBITDA growth, the consolidation that has occurred to date (and much more to come), and cautiously optimistic regarding improving demand and pricing over the next year. *Please see our companion notes on AT&T, Sprint (FON), and Level (3) for company-specific information, as well as our forthcoming industry report (under the same title as this note) and company reports for extensive details developing the themes outlined in this note. We will be hosting an investor call today at 10:30 a.m. EST; the dial-in numbers: (800) 706-8249 (US), (706) 634-5881 (Intl), and 0(800) 953-0406 (UK toll-free), and the conference ID is 3972920.*

Figure 1: Enterprise Telecom Services Coverage Universe

Company Rating, Target & Enterprise Value						
Company	**Ticker**	**Price**	**LEH Rating**	**Price Target**	**Enterprise Value $B**	**Investment Thesis Synopsis**
AT&T	T	$19.08	**1-OW**	$24	$23.5	Dominant Large Enterprise Carrier; Good value & further margin improvement likely; Divs & FCF provide strong value support
Level 3	LVLT	$5.33	**1-OW**	$7	$8.1	A wholesale leader & consolidator; Strong Gwth opps & dilution manageable; No liq. issues
MCI	MCIAV (when issued)	$25.26	**NR**		$11.7	Restructuring opportunity, with growth upside, but a lot to prove; await audited financials
Sprint	FON	$15.22	**2-EW**	$18	$13.8	Local business supports FON-Commercial, gwth limited; Strong value support at $16

Investment Thesis: Enterprise Telecom; A Comeback Begins

- We expect a cyclical up-tick, improved operational/financial efficiencies, and industry consolidation to drive stabilizing revenues, materially improved margins and 10% EBITDA growth in 2004 for the commercial units of the Enterprise Carriers in our coverage group. These factors are expected to drive increasing cashflows to equity holders via dividend increases, share buybacks, and operating free cashflow.

- In general, we favor Carriers with greater exposure to the high-end of Enterprise telecom, particularly Wholesale, and less exposure to SME. While competition is intense across the sector, we believe it is poised to improve in 2004 within the Wholesale market, while it is likely to intensify within SME, as the RBOCs aggressively attack that market. We believe Wholesale/Large Enterprise revenue comparisons and margins will improve throughout 2004, while SME revenues and margins remain weak.

- We believe that the supply/demand imbalance has finally begun to stabilize – on the supply side, we estimate that North American fiber route miles could be reduced by up to 30% within 1-2 years (already about 11% reduced) – on the demand side, we are seeing early signs of improvement in commercial bandwidth requirements (our Enterprise Demand Index and Fortune 500 Survey).

- Enterprise coverage group valuations hover near 10-year lows, as investor sentiment remains uniformly abysmal. High-end carriers with the most efficient networks and improving sequential revenues and margins offer compelling cyclical/recovery investments – Level (3) is our top pick in this regard – while AT&T is our best value pick.

Enterprise Carrier – Coverage Group Highlights:
Within our Enterprise Telecom Services coverage universe, we include telecom carriers that derive more than 50% of their total revenues from commercial users, with an emphasis on carriers that specialize in service delivery to Large Enterprises (Fortune 1,000 enterprises) and Wholesale users. This includes the following coverage stocks:

- <u>AT&T (1-OW, PT=$24):</u> Assumption of coverage with ratings and price target increases from 2-EW and $22 respectively. AT&T is our top value pick in the group as it trades at a low 3.0x ‘04 EBITDA, has a 5% dividend yield and a massive $3.5 billion in expected ‘04 FCF. We believe BS margins will expand 100 bps in ‘04, improving BS EBITDA growth to 1% (up from -12% in 2003). While consolidated revenues and EBITDA will still decline in ‘04, the CS drag is not as much as originally expected. Combined, these factors are driving a greater discounted value of cashflows, driving our upgrade on the stock. Likely further dividend increases or share buybacks in the next few months should also support the stock.

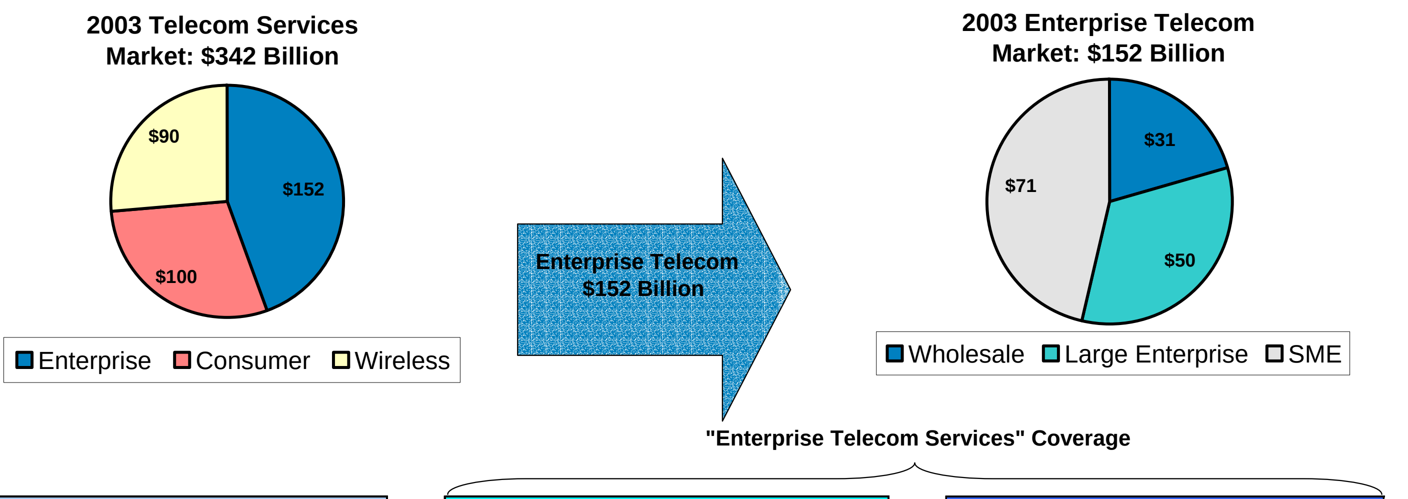
- <u>Level (3) (1-OW, PT=$7):</u> Initiation of coverage as our top pick in the sector, given its pure-play Wholesale position, operating momentum, liquidity, and improving balance sheet. The company is experiencing sequential revenue growth and delivered 380 bps in sequential Communications EBITDA margin improvement in 3Q. We expect Communications revenues to grow 9% in ‘04, while EBITDA should grow 29%. Leverage and dilution are less of an issue as the company is FCF-positive, has no material debt maturities until ’08, is more modestly 55% debt-to-enterprise value leveraged and no convertible strike prices until $7.18.

- <u>Sprint-FON (2-EW, PT=$18):</u> Assumption of joint coverage with its rating maintained at 2-EW, but an increased $18 price target (up from $14). We expect FON to cut costs aggressively in ’04, which should drive 3% EBITDA growth, despite nearly 3% revenue declines. By 2006 we expect EBITDA margins to expand by more than 400 bps, driving our increased price target. Company has strong value support at $16, an implied $1,800 per local access line valuation, and a healthy balance sheet. Revenue growth will remain challenging, however, driving our maintained 2-EW rating.

- <u>MCI (Not Rated):</u> We are initiating coverage on the when-issued equity of MCI Communications, <u>but await audited financials, more insight from management, and an exchange--traded equity before issuing a rating and price target.</u> Operationally, we believe the company has significant upside opportunities, as highlighted in the company’s bankruptcy disclosure documents, but also a lot to prove. Facilitating this opportunity is the company’s increased financial flexibility, resulting from its restructured and lean balance sheet (approximately $3.5 billion in net debt).

Enterprise Telecom Services – Defining the Industry:
In evaluating the overall Enterprise Telecom Services market, we include all the assets, financing, revenues and cashflows associated with the units servicing commercial customers. We have constructed our industry compilation using both bottom-up and top-down methodologies, factoring in data from internal sources, company feedback and FCC reports. Importantly, although we include all relevant information from any carrier selling commercial services in our industry compilation, we specifically define “Enterprise Carriers” within this report as carriers that specialize in service delivery to Large Enterprise and Wholesale customers and that receive more than 50% of their revenues from commercial clients. Therefore, the primary Enterprise Carrier segment is comprised of the incumbent IXC group (AT&T, MCI, Sprint), the emerging Network Carriers (Level (3) and its competitors), and the remaining CLECs. We estimate that the broad Enterprise market totals $152 billion in 2003 revenue, or approximately 45% of the total telecom services market and 60% of the wireline services market. Within Enterprise, we estimate that $31 billion is Wholesale (20% of Enterprise), $50 billion is Large Enterprise (33%), and $71 billion is SME (47%). Our research effort will focus on the Wholesale and Large Enterprise segments, where the Enterprise Carriers are best positioned to create long-term shareholder value. We outline the Enterprise market below.

Figure 22: Enterprise Telecom Services – A Massive Market with Distinct Segments



SME
* Dominated by RBOCs & LECs
* Highly fragmented
* Less sophisticated services
* Local/Regional Infrastructure Required
* Key Products (wireline):
  - Local & LD Voice
  - T-1/fractional, DSL, low-end data

Large Enterprise
* Dominated by AT&T, MCI, Sprint
* '03 Mkt Shrs: T = 26%, MCI = 14%, FON = 8%
* National/Global WAN & customer service/ support infrastructure req. (many POPs)
* Fortune 1,000 focus
* Customized data/voice/network integration
* Key Products (wireline):
  - Private LAN-to-WAN services
  - Dedicated Hi-cap circuits
  - Public IP access & security
  - LD & Local Voice (PBX)

Wholesale
* Currently Dominated by AT&T, MCI
* Sprint, Qwest, Level (3) are next tier
* National/Global WAN & customer service/ support infrastructure req. (fewer POPs)
* Top 300 global users of bandwidth: IXCs, ILECs, CLECs, ISPs, PTTs, Cable, Sat.
* Customized data/voice/network integration (with more real-time provisioning & service)
* Key Products (wireline):
  - Similar to Large Enterprise, only more capacity, faster provisioning

Expected Enterprise Carrier Improvements:
We expect a cyclical up-tick, significant operational/financial improvements, and industry consolidation to drive stabilizing revenues, materially improved margins and 10% EBITDA growth in 2004 for the commercial units of the Enterprise Carriers in our coverage group. These factors are expected to drive increasing cashflows to equity holders via dividend increases, share buybacks, and growing operating free cashflow (OFCF).

- A modest cyclical up-tick, led by estimated 5% growth in 2004 Fortune 500 telecom service budgets (versus 5% declines in 2003), is expected to stabilize 2004 revenues for our Enterprise Carrier coverage group commercial revenues at -1% (versus -6% in 2003).

- A 25% reduction in headcount from 2000 to current has driven an 18% improvement in productivity per employee. Combined with the benefits of other massive network and systems cost/efficiency initiatives, we expect Enterprise Carriers to improve 2004 EBITDA margins 220 bps and grow EBITDA 10%.

- Industry consolidation, and bidding-ineligibility by weaker players, has reduced the number of bidders per contract from 8-10 in 2001 to 4-6 today. We expect increased financial slack resulting from reduced leverage to help drive ongoing consolidation of weaker, cashflow-negative carriers. Industry debt is down 58% from 2001 to 2003 ($224 billion to $95 billion) and debt/EBITDA has declined from 6.8x to 3.1x.

Figure 3: Expected 2004 & 2005 Enterprise Carrier Improvements

	2000	2001	2002	2003f	2004f	2005f
Enterprise Industry:						
Revenue Growth	**13.7%**	**1.6%**	**-7.0%**	**-4.7%**	**2.1%**	**4.6%**
bp Change		-1210 bp	-860 bp	230 bp	680 bp	250 bp
# of Bidders per Contract	**8-10**	**8-10**	**8-10**	**4-6**	**3-5**	**3-4**
Enterprise Carrier Coverage Group: Commercial Metrics						
Revenue Growth	**6.4%**	**0.6%**	**-6.1%**	**-6.3%**	**-0.6%**	**3.6%**
bp Change		-580 bp	-670 bp	-20 bp	570 bp	420 bp
Headcount (000)	**164**	**150**	**129**	**123**	**123**	**123**
% Change		-8.8%	-13.8%	-4.9%	0.0%	0.0%
Rev. Productivity/Employee ($ 000)	**$382**	**$421**	**$459**	**$452**	**$449**	**$466**
% Change		10.3%	9.0%	-1.6%	-0.6%	3.6%
EBITDA Margins	**30.1%**	**25.0%**	**23.8%**	**21.2%**	**23.4%**	**25.5%**
bp Change		-510 bp	-120 bp	-260 bp	220 bp	210 bp
OFCF ($ bil)	**($9.8)**	**($11.2)**	**$6.2**	**$6.2**	**$4.6**	**$5.2**
Leverage (Consolidated Debt/EBITDA)	**5.6x**	**6.8x**	**3.8x**	**3.1x**	**2.7x**	**2.4x**

Favor Exposure to High-End Enterprise:
In general, we favor Enterprise Carriers with greater exposure to the high-end of Enterprise telecom and Wholesale, and less exposure to SME. While competition is intense across the Enterprise market, we believe it is poised to improve in 2004 within the Wholesale market, while it is likely to intensify within SME for Enterprise Carriers, driven by the RBOCs. Early signs of this were evident in Enterprise Carrier 3Q03 earnings reports, as renewed point-of-sale long distance and low-speed private line price declines added a discernable drag to revenues.

- The operational and financial improvements expected for 2004 should flow most directly to the high-end of the Enterprise market, due largely to the core nature of the improvements and to the improving competitive landscape within those segments.

- The 2004 growth and margin outlook is better for Enterprise Carriers within the Wholesale segment, driven ironically by increasing competition within the SME and Consumer market segments by traditional and non-traditional carriers that lack a national backbone and rely on wholesalers to provide the wide area networking.

- Despite the much publicized hyper-competition within the Wholesale market, we believe this segment is the one best positioned to see improving competitive dynamics in 2004, as the number of competitors and network miles are expected to decline.

- While SME has better margins and good long-term growth, to the incumbent Enterprise Carriers it represents the segment expected to most intensify competitively in 2004, as competitive threats emerge from well-funded and aggressive RBOCs. SME revenues are expected to cause 100 bps drags to commercial revenue growth for AT&T and MCI in 2004.

- The following table highlights that AT&T and MCI have the largest long distance SME exposure, while Sprint has materially less and Level (3) has none. Of note, Level (3) derives 100% of its revenues from the portion of the market we expect to perform the best in 2004 (Wholesale).

Figure 4: Enterprise Carrier SME Exposure

	SME		**High-End**		
Enterprise Carrier	**LD SME**	ILEC SME	**Total High-End**	Wholesale	Large-Enterprise
AT&T Bus. Serv.	**24%**	0%	76%	24%	52%
MCI Commercial	**28%**	0%	72%	33%	39%
FON-Commercial	**14%**	23%	62%	22%	41%
Level (3)	**0%**	0%	100%	100%	0%
Enterprise Carrier Avg.	**23%**	2%	75%	30%	45%

Improving Supply/Demand Balance:

We believe that the supply/demand imbalance that has plagued the industry has finally begun to stabilize. On the supply side, we estimate that North American fiber route miles could be reduced by a cumulative 30% within 1-2 years (already about 11% reduced). Additionally, the number of bidders per contract has fallen from 8-10 in 2001 to 4-6 today (and likely 3-5 by 2004). On the demand side, we are seeing the early signs that commercial bandwidth requirements are beginning to improve, as indicated by our Enterprise Demand Index improvements and our Fortune 500 Survey. Currently, we are forecasting a modest recovery, but if job growth and technology sales continue accelerating at current rates there could be upside to our numbers.

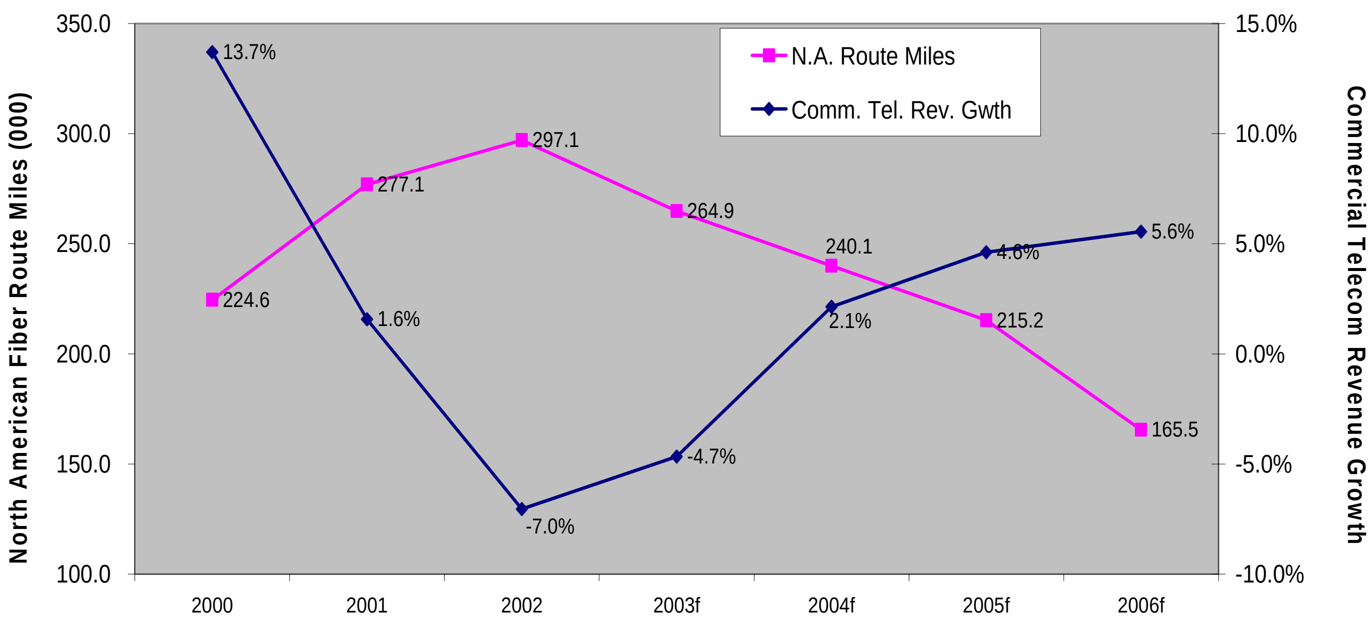
- To date, one US-based network carrier has been consolidated and its network decommissioned (Genuity), and a European carrier is scaling back its US operations.

- Another two carriers will likely consolidate within 1-2 years, as they remain cash-flow-negative and have limited access to capital .

- Enterprise telecom is a cyclical business – we believe we have found two reliable leading indicators in terms of forecasting changes in commercial telecom services revenue growth, namely employment growth and semi-conductor revenue growth, and constructed an Enterprise Demand Index (EDI).

- Our EDI score of 0.5 signals an expected moderate improvement to current 4% Enterprise telecom service revenue declines (to begin by 2Q04), while our Fortune 500 Survey indicates an expected 5% increase in 2004 telecom service spending, up from -5% in 2003.

Figure 5: Decreasing Fiber Route Miles Supports Improving Enterprise Telecom Services Industry Revenue Growth



Diverging 2004 Performance – High-End Turning the Corner

While overall revenues for our Enterprise Carrier coverage group are expected to decline 1% in 2004, this masks two diverging trends that we expect to develop throughout the year – improving quarterly Wholesale/Large Enterprise revenue growth and margins versus continued SME revenue declines and pressured margins.

- Expected 1% declines in 2004 Enterprise Carrier revenue masks important underlying trends that favor the high-end of the market, namely improving revenue growth and margins, driven by improving demand and cost reduction initiatives.

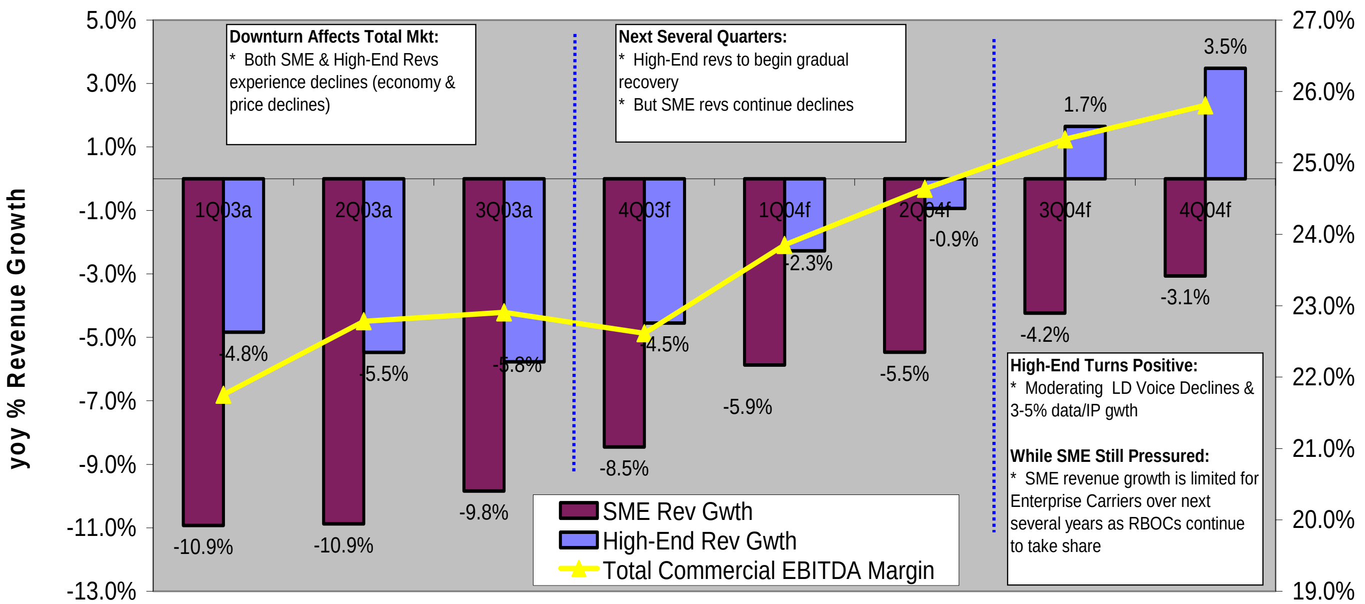
- We expect Wholesale/Large Enterprise revenue growth will see improving quarterly yoy growth rates, driven by improving competitive dynamics, better pricing stability and key growth-product opportunities (VoIP and MPLS-enabled LAN-to-WAN services). By 4Q04, we expect high-end revenues will be growing 3.5% yoy for our Enterprise Carriers, while SME is still expected to be declining 3.1%.

- While VoIP does not represent a net growth opportunity to the incumbent market, it does represent a material Wholesale opportunity given that the retail providers of this new service mostly lack a national backbone and will rely on wholesalers.

- Additionally, MPLS-enabled services marketed to enterprises, by RBOCs in particular, provide another such Wholesale growth opportunity .

- We expect Wholesale/Large Enterprise to benefit most from cost-reduction initiatives. Since most of these center around the network core and related systems, the benefits should flow mostly to services that most intensively utilize the core.

Figure 6: Diverging 2004 Performance within Enterprise – High-End Versus SME



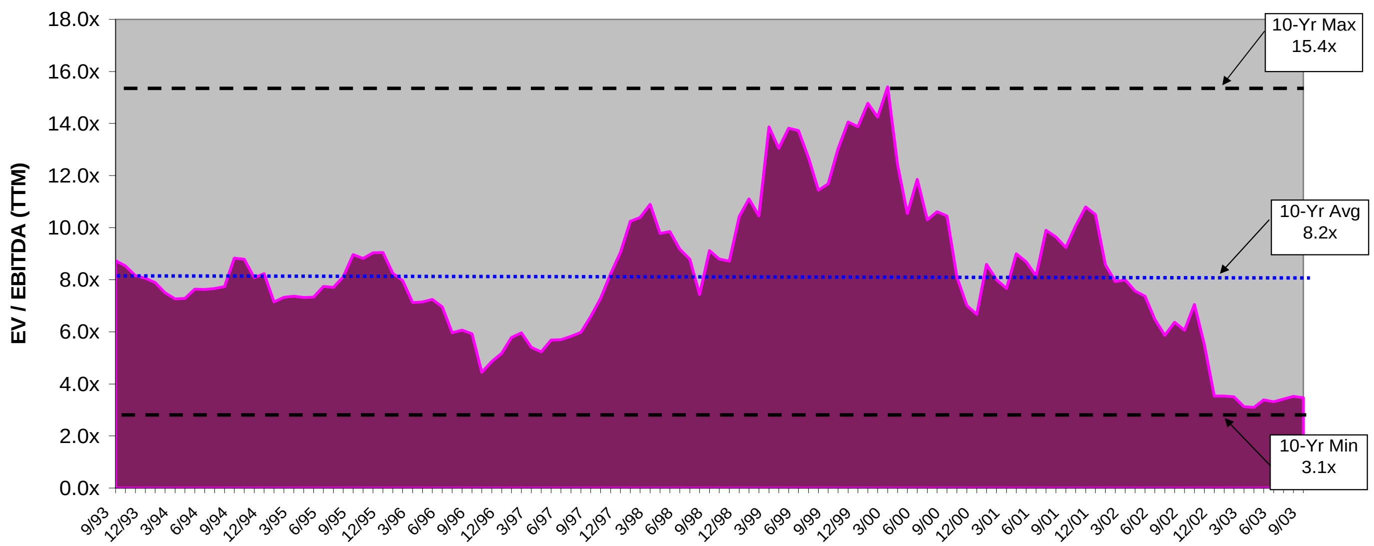
Valuations at 10-Year Lows – Provides Targeted Opportunities:
Enterprise coverage group valuations hover near 10-year lows, creating investment opportunities as the entire sector remains tarred with a broad brush. High-end carriers with the most efficient networks and improving sequential revenues and margins, and less exposure to SME, offer investors the chance to buy at a market-bottom values that do not yet reflect their improving underlying fundamentals.

- Level (3) is our top pick in the space, with its Wholesale pure-play model, its industry leading margins (that continue to improve sharply, up 380 bps in 3Q), its FCF-positive status and improving balance sheet. It is most cleanly positioned to benefit from the improvements we expect in the Enterprise market in 2004. We believe the bear case valuation is $6 and buy aggressively below this level.

- AT&T, while exposed to SME, is our top value pick, given its dominant position within Large Enterprise, improving margins, and very cheap valuation at 3.0x 2004 EBITDA. While revenue and EBITDA growth will remain pressured due to Consumer/SME drags, we believe the discounted value of cashflows is worth more than current market prices. A 5%+ dividend yield and potential for additional dividend increases and/or share buybacks should provide strong support for the stock.

- MCI offers strong potential upside, given its vast opportunity for margin improvement. Based on the current when-issued trading levels, the company is trading modestly above AT&T, at 3.4x 2004 EBITDA. We await audited financials and more insight from management in order to fully develop our thesis.

Figure 7: Enterprise Carrier Coverage Group's Valuation Hovering at 10-Yr Lows – EV / EBITDA Multiple



Valuations – Enterprise Carriers Low Vs. Rest-of-Telecom:
We believe that the operating environment is beginning to improve for the carriers within our Enterprise coverage group and that valuations do not yet reflect this, providing an opportunity for patient investors to enjoy a favorable risk/return relationship.

- Fortunately, cycles proceed. We believe valuations and multiples are poised to expand as operational and financial improvements have positioned the stronger Enterprise carriers to benefit in a leveraged fashion from improvements in the commercial economy.

- This process of value-expansion should be greatly enhanced by industry consolidation, which we believe is ripe to occur and should be seen as a catalyst for valuation appreciation in the sector. Other catalysts will be continued improvements in employment and technology and productivity increases (with semiconductor chip sales being a reasonable proxy).

- The following table summarizes our new Enterprise Carrier sector in relation to the other telecom service sector stocks covered by Lehman Brothers. The Enterprise group stands out as the having the lowest market valuation, at 3.5x EBITDA versus the next-nearest group (the RBOCs) at 4.8x. To highlight the disparity, we estimate that Enterprise Carriers comprise 25% of Lehman Telecom Services coverage revenue, and 17% of EBITDA, but only 12% of the market capitalization. Given that we believe fundamentals are poised to improve, we believe the sector has good value at these levels.

Figure 8: Enterprise Carrier Valuation Low Relative to Lehman Telecom Services Coverage Universe

	RBOCS	**National Wireless**	**RLECs**	**Enterprise Tel.**	**Small Wireless**
	BellSouth Qwest SBC Communications Verizon	AT&T Wireless Nextel Sprint PCS	Alltel Century Tel. Commonwealth Tel. Citizens Comm. US Cellular TDS	AT&T MCI Sprint Level (3)	
$ Bil					
2003 Revs	$161	$37	$16	$73	$9
% of LEH-Cvg	54%	12%	5%	**25%**	3%
2003 EBITDA	$61	$12	$7	$16	$3
% of LEH-Cvg	61%	12%	7%	**17%**	3%
Market Cap	$225	$46	$27	$42	$15
% of LEH-Cvg	63%	13%	8%	**12%**	4%
EV/EBITDA	4.8x	6.6x	6.6x	**3.5x**	11.8x

Price Target Methodologies:
FON: Our new $18 price target is based on an average of DCF and EV/EBITDA multiple, versus expected growth methodologies, and implies a modest multiple expansion to 3.6x 2004 EBITDA, still low versus historical averages.

T: We value AT&T shares based on DCF and EV/EBITDA multiples relative to growth. Based on these metrics, we find strong price support levels for AT&T at $19 per share, based on the EV/EBITDA multiple versus growth method, with a higher DCF-value, at $32 per share. Our $24 price target represents a weighted average of DCF and EV/EBITDA multiple methods, with a $2 per share haircut to account for variability in valuation driven by different CS assumptions in the out years.

LVLT: Our DCF valuation results in a $7 per-share price target, using a 10.3% WACC and a 4.5% terminal growth assumption. We believe the bear case downside is $6 per share and the bull case upside is $8 per share. Our target is based on the assumption that management does not issue significant incremental equity in the near term.

Enterprise Carrier Coverage Group – Improving Commercial Outlook:
We expect a cyclical up-tick, significant operational/financial improvements, and industry consolidation to drive stabilizing revenues, materially improved margins and 10% EBITDA growth in 2004 for the commercial arms of the Enterprise Carriers in our coverage group. These factors are expected to drive increasing cashflows to equity holders via dividend increases, share buybacks, and growing OFCF.

- Estimated 5% growth in 2004 Fortune 500 telecom service budgets (versus 5% declines in 2003) is expected to stabilize 2004 commercial revenues for our Enterprise Carrier coverage group at -1% (versus -6% in 2003). We expect 2005 Enterprise Carrier commercial revenues to grow nearly 4%, and long-term average annual growth of 4%.

- Enterprise Carriers have significantly pared cash operating expenses and are poised to reap meaningful returns as the commercial economy improves. A 25% reduction in headcount from 2000 to current has driven an 18% improvement in productivity per employee. Combined with the benefits of other massive network and systems cost/efficiency initiatives, we expect Enterprise Carriers to improve 2004 commercial EBITDA margins 220 bps and grow commercial EBITDA 10%.

- We expected continued strong margin gains in 2005, at +210 bps, driving expected EBITDA growth of nearly 13%. Between now and 2010, we expect commercial EBITDA will grow at an average annual rate of nearly 9%.

- Capex has also been reigned in and targeted on core efficiency upgrades and success-based spending. We expect it to normalize at 8-10% of revenues, enabling healthy 3-4% commercial OFCF growth rates from 2003 to 2010.

Figure 9: Enterprise Carrier Coverage Group: Improving Commercial Outlook

($ Bil)	2000	2001	2002	2003	2004f	2005f	'03 to '10 CAGR
Revenue	**$62.7**	**$63.0**	**$59.2**	**$55.4**	**$55.1**	**$57.1**	**3.6%**
% Growth	6.4%	0.6%	-6.1%	-6.3%	-0.6%	3.6%	
Opex	**$43.8**	**$47.3**	**$45.1**	**$43.7**	**$42.2**	**$42.6**	**1.9%**
% Growth	8.0%	8.0%	-4.5%	-3.2%	-3.4%	0.9%	
EBITDA	**$18.9**	**$15.8**	**$14.1**	**$11.8**	**$12.9**	**$14.5**	**8.5%**
% Growth	20.8%	-16.5%	-10.7%	-16.4%	9.8%	12.6%	
Margin	30.1%	25.0%	23.8%	21.2%	23.4%	25.5%	
Capex	**$22.2**	**$17.6**	**$6.5**	**$5.3**	**$5.8**	**$6.1**	**5.9%**
% Growth	19.1%	-20.8%	-62.9%	-18.8%	9.8%	4.5%	
% of Rev	35.5%	27.9%	11.0%	9.6%	10.6%	10.6%	
OFCF(1)	**($9.8)**	**($11.2)**	**$6.2**	**$6.2**	**$4.6**	**$5.2**	**3.3%**
% Growth	16.0%	13.9%	-155.6%	-0.6%	-26.6%	14.9%	
Margin	-15.7%	-17.8%	10.5%	11.2%	8.3%	9.2%	
Commercial Telecom Employees (000s)	**164.1**	**149.6**	**129.0**	**122.7**	**122.7**	**122.7**	**n/m**

(1) Operating Free Cash Flow is defined as CFFO - capex.

Enterprise Telecom Services Comparables:

Figure 10: Enterprise Comps

Company & Enterprise Value													
Stock Information				Enterprise Value					Investor Returns				
									Current Yields		Stock Performance: % Return		
Company	Ticker	Price	Shares Out	Mkt.Cap	Net Debt	Non-Con. Assets	Enter. Value	Book Equity	Div Yld	ROA	Week	Month	YTD
AT&T(1)	**T**	**$19.08**	**789**	**15.1**	**8.5**	**0.0**	**23.6**	**13.6**	**5.0%**	**7.6%**	**1%**	**-5%**	**-27%**
T Bus. Serv.(2)										4.6%			
MCI(1)	**MCIAV**	**$25.26**	**326**	**8.2**	**3.4**	**0.0**	**11.7**	**8.4**	**0.0%**	**6.5%**	**1%**	**-5%**	**-27%**
MCI Comm.(2)										3.6%			
Sprint(1)	**FON**	**$15.22**	**903**	**13.7**	**0.0**	**0.0**	**13.8**	**13.3**	**3.3%**	**8.7%**	**-6%**	**-3%**	**5%**
FON Comm.(2)										4.2%			
Level 3(1)	**LVLT**	**$5.33**	**653**	**3.5**	**4.5**	**0.0**	**8.0**	**0.3**	**0.0%**	**-1.9%**	**-4%**	**-1%**	**9%**
L3 Comm.(3)										-5.1%			
XO Comm.	XOCM	$5.30	95	0.5	0.2	0.0	0.7	0.5	0.0%	-6.6%	-2%	-1%	N/A
Time Warner	TWTC	$10.16	115	1.2	0.8	0.0	2.0	0.5	0.0%	-1.8%	-7%	-13%	382%
Enterprise Avg.(Largecap for Div & ROA)									2.8%	4.2%	-3%	-5%	68%
S&P 500 Avg.	SPX	$1,047									-1%	1%	19%

Operating Statistics													
Stock Information		Revenue				EBITDA				EPS			
	LEH	2003		2004		2003		2004		2003		2004	
Company	Rating	$ Bil	% Gwth	$ Bil	% Gwth	$ Bil	Margin	$ Bil	Margin	$	% Gwth	$	% Gwth
AT&T(1)	**1-OW**	**34.7**	**-8.1%**	**32.9**	**-5.4%**	**8.7**	**25.1%**	**7.9**	**24.0%**	**$2.28**	**-17.2%**	**$1.73**	**-24.3%**
T Bus. Serv.(2)		25.2	-5.3%	24.5	-2.5%	6.8	26.9%	6.8	27.9%				
MCI(1)	**NR**	**24.5**	**-16.3%**	**24.0**	**-1.7%**	**2.7**	**11.2%**	**3.4**	**14.3%**	**N/A**	**N/A**	**$2.76**	**N/A**
MCI Comm.(2)		18.2	-11.4%	18.3	0.8%	2.0	11.2%	2.8	15.4%				
Sprint(1)	**2-EW**	**14.1**	**-7.0%**	**13.8**	**-2.6%**	**4.4**	**31.1%**	**4.5**	**32.9%**	**$1.45**	**7.5%**	**$1.55**	**6.4%**
FON Comm.(2)		9.3	-5.6%	9.3	-0.6%	2.5	26.8%	2.7	28.5%				
Level 3(1)	**1-OW**	3.6	26.6%	3.6	-1.2%	0.4	12.1%	0.6	16.4%	($1.18)	N/M	($0.98)	N/M
L3 Comm.(3)		**1.6**	**2.9%**	**1.8**	**9.0%**	**0.4**	**27.3%**	**0.6**	**32.2%**				
XO Comm.		1.2	-7.2%	1.2	6.7%	0.0	1.1%	0.0	1.8%	($1.28)	N/M	($1.08)	N/M
Time Warner		0.7	-7.0%	N/A	N/A	0.2	28.6%	N/A	N/A	($1.06)	N/M	($0.89)	N/M
Enterprise Ind.		151.6	-4.7%	154.8	2.1%	31.0	20.4%	32.9	21.3%				

Valuation Multiples & Capital Structure													
Stock Information		EV / Revenue		EV / EBITDA		EV / OFCF		P/E Ratio		Leverage Ratios		Coverage Ratios	
	Price									Nt Debt /	Nt Debt /	Unlev. '04	
Company	Target	2003	2004	2003	2004	2003	2004	2003	2004	Capital	'04 EBITDA	OFCF / Int.	
AT&T(1)	**$24**	**0.7x**	**0.7x**	**2.7x**	**3.0x**	**4.0x**	**6.9x**	**8.4x**	**11.1x**	**38.5%**	**1.1x**	**4.6x**	
T Bus. Serv.(2)		0.9x	1.0x	3.5x	3.4x	5.6x	8.4x						
MCI(1)	**NR**	**0.5x**	**0.5x**	**4.3x**	**3.4x**	**5.3x**	**11.5x**	**N/A**	**9.2x**	**29.0%**	**1.0x**	**3.4x**	
MCI Comm.(2)		0.6x	0.6x	5.7x	4.1x	5.3x	11.5x						
Sprint(1)	**$18**	**1.0x**	**1.0x**	**3.1x**	**3.0x**	**8.0x**	**6.9x**	**10.5x**	**9.8x**	**0.2%**	**0.0x**	**9.0x**	
FON Comm.(2)		1.5x	1.5x	5.5x	5.2x	12.8x	11.5x						
Level 3(1)	**$7**	**2.2x**	**2.2x**	**18.2x**	**13.6x**	**N/A**	**115.1x**	**N/A**	**N/A**	**93.1%**	**7.7x**	**1.1x**	
L3 Comm.(3)		5.0x	4.5x	18.1x	14.1x								
XO Comm.		0.6x	0.5x	53.2x	30.0x	N/A	N/A	N/A	N/A	23.3%	7.4x	No Cash Int.	
Time Warner		2.8x	N/A	9.8x	N/A	N/A	N/A	N/A	N/A	61.5%	N/A	N/A	
Enterprise Avg.(Largecap)		0.7x	0.7x	3.4x	3.1x	5.8x	8.5x	9.4x	10.0x	22.6%	0.7x	5.7x	
S&P 500 Avg.													

(1) Represents consolidated, total company information (for Level 3, reflects recurring items only - excludes any dark fiber, settlement & termination)
(2) Reflects operating statistics for the commercial portion of the company; valuation statistics reflect total company market valuation as a multiple of the commercial operating unit's cashflows.
(3) Refflects recurring Communications Group items only

MCI Company Report on When-Issued Equity:

We are initiating coverage on the when-issued equity of MCI Communications, but await audited financials, more insight from management, and an exchange--traded equity before issuing a rating and price target. Operationally, we believe the company has significant upside opportunities, as highlighted in the company's bankruptcy disclosure documents, but also a lot to prove. Facilitating this opportunity is the company's increased financial flexibility, resulting from its restructured and lean balance sheet. We include our full company report within this industry report since MCI does not yet have an eligible ticker under which to publish research for its new equity. The most important contributor to MCI's value proposition over the next 12 months should be its ability to shed costs while at least stemming market share losses. It is undertaking a massive network and infrastructure overhaul in order to drive more than 500 bps of margin improvement by 2005. We believe these efforts, assuming disciplined pricing, will be successful in driving significant EBITDA improvements over the next two years. If continuing margin improvement can be sustained, driving margins toward industry levels, EBITDA growth could easily exceed 15% annually, materially outperforming the sector. However, we await audited financials and more insight from management in order to fully develop our view on the stock.

Investment Thesis:

- 2004 Outlook: We believe MCI margins will expand 300 bps in 2004, improving EBITDA growth to positive 26% (up from an estimated 46% decline in 2003), despite forecasted 1.7% revenue declines (improved from a 16.0% decline in 2003). OFCF is estimated to be $1.1 billion in 2004.

- Productivity & Efficiency: MCI currently lags the Enterprise industry in most operational metrics, but particularly in EBITDA per employee. At a 2004 forecast of $68k EBITDA/employee, MCI lags the Enterprise industry average of $105k by 35% and the AT&T level of $141k by more than 50%. This is largely due to a redundant cost structure, accumulated through multiple acquisitions and a lack of infrastructure grooming. However, management is keenly focused on achieving 500 bps+ of margin improvement by 2005 (MCI lags the industry by as much as 1,000 bps).

- Streamlining the Model: We believe MCI's lower margins are driven by a combination of low pricing and the myriad networks, systems and hierarchical infrastructure built up from its acquisition roll-up/holding-company model over the years. To address this, management is converging its network to a single IP core and eliminating redundant systems. Given the magnitude of the opportunity for improvement, we believe management can achieve its goal of 500 bps+ improvement by 2005, and 50-100 bps per year for some time thereafter.

- Pricing: MCI has historically been among the most aggressive in terms of pricing, partially explaining its low margins. However, with 2003 EBITDA margins at a forecast of 10.9%, and approximately $1 billion in OFCF per year thereafter, there is not much room to cut prices further, giving us some comfort against fears of an all-out price war, although some cuts at re-emergence are likely.

- Capital Structure & Dilution: At an estimated 326-366 million outstanding shares at re-emergence and $4.7-$5.7 billion in debt, MCI will boast one of the best balance sheets in the business. Even at $5.7 billion in total debt, net debt would only be $3.5 billion, leaving net debt/EBITDA at a low 1.3x (similar to AT&T). With expected improvements in 2004 EBITDA, we expect leverage to fall to 0.7x and interest coverage to be 3.4x.

- Consumer: We expect ongoing revenue and EBITDA losses within Consumer (-5% annually for revenues and -16% annually for EBITDA over next 7 years), but believe a lower proportion of fixed costs within its Consumer unit will allow MCI to maintain positive FCF over time.

- SME Exposure: MCI maintains the second-largest SME revenue base, estimated at $5 billion in 2003, but has the largest relative exposure as a percent of commercial revenues of any of the Enterprise Carriers. We estimate that MCI will lose approximately 25 bps of share annually to the RBOCs in this segment (similar to AT&T), causing an estimated 100 bp drag to commercial revenue growth.

- Valuation: Bankruptcy documents value the restructured equity at $25 per share, however arguments could be made for a range of values, from price support at $22 per share, to premium-multiple values approaching $28, for the stock. Fundamental to determining where the stock should trend are assumptions on cost-reduction, pricing and margin-improvement potential over the next 12 months. We await audited financials and more insight from management prior to establishing a price target.

Core Business Model:
MCI is a leading provider of voice and data telecom services to 20 million residential and commercial customers worldwide. The company is structured along customer segment lines, dividing itself primarily into Business, International, and Mass Markets segments. For purposes of this report and our modeling, we have attempted to group revenues and expenses into just two buckets, Commercial ($18 billion in revenue) and Consumer ($6 billion in revenue). In this regard, we include International within Commercial since the vast majority of its business involves multinational corporations. While the new corporate structure is not yet totally evident, we believe the Commercial unit will own and operate the fiber network and related POPs and lease capacity to the Consumer unit on a volume basis (we believe that Consumer will own a number of Class 5 voice switches and related network interface devices).

MCI's Commercial unit is second-largest Enterprise telecom services provider in the US and offers a full suite of facilities-based long distance voice and data network services – it maintains a relationship with most of the Fortune 1000 companies and has historically maintained the largest Wholesale business in the US, although estimated share loss due to the bankruptcy process in 2003 has likely driven MCI to a number two Wholesale share spot (below AT&T). As the company re-emerges from bankruptcy, we believe MCI will be particularly focused on regaining share losses within its historic Top 500 accounts (similar to AT&T's increasing focus) and is reconfiguring its network, support and client-facing infrastructure to accommodate this. In this regard, significant network, systems, headcount and bankruptcy-driven restructuring changes are underway in efforts to bring MCI's profitability up to industry levels. This is clearly the number one challenge for management, and without question the central item in MCI's value proposition over the next several years.

Where there is much challenge, there is much opportunity, but the path won't be easy. MCI has historically operated as a holding company that overseas the myriad autonomous companies it has acquired since the 1980s. This has helped lead to the lower margins it maintains versus it peers, due to the layers of inefficient legacy systems, redundancies and parallel network protocols inherent in this structure. By some estimates, MCI maintained at one point more than 400 internal systems (versus AT&T with 140+ at its peak). To address these inefficiencies, MCI announced in April an initiative to overhaul its network, migrate traffic to a single IP core, and streamline its systems. It plans to have 25% of its voice traffic running over its IP core by year-end 2004, but these leaves it somewhat behind the incumbent peers, who are aggressively building out migration paths to a single core in 2003. Nonetheless, success in these areas could lead to significantly faster-than-industry cashflow growth, due to degree of MCI's current margin lag (AT&T Business Services 26.5% 2003 EBITDA margin versus MCI Commercial at an estimated 10.9%).

The Consumer unit is the second-largest provider of residential long distance services in the US and counts an estimated 18 million customers as its client base. The unit is aggressively deploying a non-facilities-based UNE-P local strategy in order to offer a bundled local/long distance, fixed-rate service in efforts to reduce the severity of secular competitive and substitution declines in the mature Consumer long distance voice product. While the local service itself has limited profit potential, its bundled offering with long distance is proving to be effective at reducing competitive losses to RBOCs and substitution to wireless. And while the local/long distance bundle is slowing the rate of customer defection, MCI's smaller overall share within Consumer (versus AT&T), combined with its broader UNE-P scope (48 states versus 35 states for AT&T) is likely to make a thin-margin product even less profitable, making us wonder how long MCI will maintain such a broad deployment. According to our forecasts, MCI's stand-alone UNE-P product will not reach breakeven until 2006 (versus AT&T in 2005), due to its higher costs of service (UNE-P rates), resulting from deployment into less urban areas, and lower effective ARPUs (for similar reasons). Nonetheless, if the product's deployment helps stabilize the overall business in the near-term, we believe it is the best course of action. And if the Consumer infrastructure can be dynamically scaled to match decreasing volumes over time, the current local/long distance strategy may prove the most effective way of maximizing cashflows and harvesting a declining, mature product.

The following table summarizes the relative size of the MCI's Commercial and Consumer units. The table highlights that Commercial revenues (including International) are estimated to be 74% of 2003 MCI total revenues and are expected to grow to 84% of revenues by 2010. Commercial revenues are expected to grow 4% annually over this period, while Consumer revenues are expected to decline approximately 5% annually.

Figure 11: MCI Commercial & Consumer Revenues

	2001		2003f		2005f		2010f	
Revenue ($ Bil)	Revs	% of Total	Revs	% of Total	Revs	% of Total	Revs	% of Total
Commercial (Inc. Intl)	$22.7	67%	$18.2	74%	$19.1	78%	$24.1	84%
% Growth	4.8%		-11.4%		4.6%		4.2%	
Consumer	$11.2	33%	$6.3	26%	$5.3	22%	$4.5	16%
% Growth	-13.6%		-27.9%		-7.2%		-2.1%	
MCI Consolidated	$33.9	100%	$24.5	100%	$24.5	100%	$28.6	100%
% Growth	-2.1%		-16.3%		1.8%		3.2%	

A Brief Bankruptcy History:
On June 25, 2002, the Company announced that as a result of an internal audit, it was determined that transfers from line cost expenses to capital accounts in the amount of $3.9 billion were not made according to GAAP. Subsequent announcements over the course of the summer 2002 indicated that additional improperly recorded transfers and accounting we identified and that the ultimate size of the eventual restatements could exceed $9 billion and involve 1999, 2000, 2001 and 1Q02.

KPMG is the Company's new auditor and conducted this review and restatement process. It also conducted an internal controls audit, which is being relied upon by the Federal government as the guideline as to when MCI may have its current suspension from new GSA business lifted. It has been alleged that the improper transfers at the core of this matter were intentional and done at the direction of various senior management personnel. As such, the entire senior management team of MCI has essentially been removed and replaced, as has the Board of Directors.

There remain outstanding criminal and civil legal challenges to MCI and some of its former senior management related to these matters, as well as other alleged improper access-charge and call-routing practices. Resolution of these matters are uncertain, but they have not impeded the Bankruptcy Court's decision to approve the restructuring transaction, or the creditors agreement to this restructuring, indicating that that outcome of such legal matters is not perceived by the concerned parties as likely to be catastrophic in nature.

On July 21, 2002 WorldCom, Inc. (the "Company") and most of its direct and indirect domestic subsidiaries filed voluntary petitions for relief in the United States Bankruptcy Court for the Southern District of New York under Chapter 11. On November 8, 2002 43 additional, but mostly inactive, subsidiaries filed Chapter 11 and the cases were all consolidated, while the company continued to operate its business as debtors-in-possession. On April 14, 2003 the Company filed a Plan of Reorganization and on May 28, 203 the Bankruptcy Court approved the Disclosure Statement, allowing solicitation of creditors' approval. Solicitation began on June 13, 2003, but on July 31, 2003 the Bankruptcy Court postponed the expected August 13, 2003 Confirmation Hearing until September 8, 2003 in order to permit the Company to file an additional Disclosure Statement addressing issues relating to the investigation of its call-routing practices by the US Attorney's Office and the impact of the July decision by the GSA to propose debarment of the Company for the purposes of soliciting and contracting new government business.

There remains a current suspension of MCI's ability to gain new government contracts pending on ongoing review of the Company's internal controls improvements and related items. The Company filed this updated Disclosure Statement on August 4, 2003, which was approved by the Court on August 6, 2003. The final Confirmation Hearing began on September 8, 2003 and on September 9, 2003 agreement was reached with the last major group of creditors, clearing the way for a final agreement.

On September 11, 2003, the Company filed a final Disclosure Statement reflecting this agreement. The final creditor vote was completed on October 7, 2003 and the final Confirmation Hearing reinitiated on October 15, 2003, where it was once again delayed until October 30. The Court gave verbal approval for the deal on October 31, and MCI's when-issued stock began trading under the ticker MCIAV on November 3. Re-emergence will become effective at some point just after the beginning of the 2004, when the Company is expected to complete and file its financial restatements and other documents and distribute its new securities. At this point the new equity will begin trading under its official ticker on an exchange to be determined.

Core Markets and Competitors:
MCI is estimated to hold the #3 market share position in terms of total Enterprise revenues, although among carriers that we designate "Enterprise Carriers" (i.e. – carriers that derive more than 50% of their revenues from commercial customers) it is the second largest (behind AT&T). We estimate MCI's 2004 overall Enterprise market share to be 11.8%, down from an estimated 13.3% in 2001, prior to bankruptcy being filed. We estimate that MCI has lost approximately $2.6 billion in annual market share over the course of its bankruptcy. However, MCI is re-emerging largely intact, with continued strong competitive positions across the Enterprise market, and particularly so within Large Enterprise, where we believe a patient approach to profitable re-acquisition of market share will lead net share gains over the next 7 years. For example, while we expect MCI as an incumbent to experience overall Enterprise share loss of 10 bps annually (through 2010), we expect the company to experience net share gains of 15 bps per year within the Large Enterprise segment of the market. The most intense competition for MCI will come at the upper and lower ends of the market, with strong emerging competition from Level (3) within the Wholesale segment and RBOC long distance entry within SME, driving estimated 10 bps and 25 bps of annual share loss respectively.

Figure 12: The Enterprise Market

Top 10 Enterprise Market Share Carriers(1) - Total Market

		2004f		2005f		2010f		
						7-Yr Rev	Market	Avg. Annual
Rank	Carrier(2)	Rev ($ bil)	Mkt. Share	Rev ($ bil)	Mkt. Share	CAGR	Share	Share Chg.
1	AT&T Bus. Serv.	$24.5	15.8%	$25.1	15.5%	2.6%	14.2%	-30 bp
2	SBC	$20.2	13.1%	$21.1	13.1%	4.7%	13.1%	00 bp
3	**MCI**	**$18.3**	**11.8%**	**$19.1**	**11.8%**	**4.1%**	**11.4%**	**-10 bp**
4	Verizon	$15.2	9.8%	$16.3	10.1%	5.5%	10.7%	10 bp
5	Sprint	$9.3	6.0%	$9.5	5.9%	2.5%	5.2%	-15 bp
6	Qwest	$8.7	5.6%	$9.2	5.7%	5.4%	5.8%	05 bp
7	BellSouth	$8.5	5.5%	$8.9	5.5%	5.4%	5.7%	05 bp
8	Level 3	$1.8	1.1%	$1.9	1.2%	10.3%	1.5%	05 bp
9	XO Communications	$1.2	0.8%	$1.4	0.9%	9.7%	1.1%	05 bp
10	Rest of Industry	$47.1	30.4%	$49.3	30.4%	6.2%	31.3%	15 bp
	Enterprise Industry	**$154.8**	100.0%	**$162.0**	100.0%	4.9%	100.0%	

(1) Represents commercial local and long distance, voice and data revenues.

Figure 13: The Large Enterprise Market

Top 5 Large Enterprise Market Share Carriers(1)

		2004f		2005f		2010f		
						7-Yr Rev	Market	Avg. Annual
Rank	Carrier(2)	Rev ($ bil)	Mkt. Share	Rev ($ bil)	Mkt. Share	CAGR	Share	Share Chg.
1	AT&T Bus. Serv.	$13.1	25.7%	$13.5	25.6%	3.5%	25.1%	-10 bp
2	**MCI**	**$7.5**	**14.8%**	**$8.1**	**15.3%**	**5.6%**	**15.8%**	**15 bp**
3	Sprint	$3.9	7.7%	$4.0	7.6%	3.0%	7.0%	-10 bp
4	Qwest	$2.2	4.4%	$2.4	4.5%	6.6%	5.1%	10 bp
5	XO Communications	$0.5	1.1%	$0.6	1.1%	9.6%	1.5%	05 bp
	Rest of LE	$23.6	46.4%	$24.1	45.8%	3.8%	45.5%	-15 bp
	Large Enterprise	**$50.9**	100.0%	**$52.7**	100.0%	**4.1%**	100.0%	

(1) "Large Enterprise" is defined as the "Fortune 1,000" Enterprises; these users generate $25 million or more annually, with average over $50 million.

(2) Represents wholesale local and long distance, voice and data revenues.

Figure 14: The Wholesale Market

Top 5 Wholesale Market Share Carriers[1]

		2004f		2005f		2010f		
						7-Yr Rev	Market	Avg. Annual
Rank	Carrier[2]	Rev ($ bil)	Mkt. Share	Rev ($ bil)	Mkt. Share	CAGR	Share	Share Chg.
1	AT&T Bus. Serv.	$5.9	18.6%	$6.2	18.4%	3.6%	16.8%	-30 bp
2	**MCI**	**$6.0**	**18.7%**	**$6.2**	**18.6%**	**4.9%**	**18.3%**	**-10 bp**
3	Qwest	$2.6	8.0%	$2.6	7.9%	3.4%	6.9%	-20 bp
4	Sprint	$1.8	5.8%	$1.9	5.7%	2.3%	5.2%	-10 bp
5	Level 3	$1.8	5.5%	$1.9	5.7%	10.3%	7.0%	30 bp
	Rest of Wholesale	$13.8	43.3%	$14.6	43.6%	7.0%	45.7%	40 bp
	Wholesale Market	**$31.9**	100.0%	**$33.5**	100.0%	**5.6%**	100.0%	

(1) "Wholesale" is defined as the "Top 300 Telco Users" worldwide; these users generate at least $75 million annually in telecom revenues

(2) Represents wholesale local and long distance, voice and data revenues.

Segment Exposure and highlights:
Approximately 26% of consolidated 2003 revenues are Consumer, which are expected to decline 9% in 2004, with EBITDA margins expected to remain steady at 11%, resulting in 9% EBITDA declines. Approximately 21% of 2003 revenues are SME, which are expected to decline 4% in 2004. However, an estimated 260 bp improvement in SME margins, due to the massive cost reduction efforts being undertaken as part of the bankruptcy restructuring, is expected to drive 12% SME EBITDA growth in 2004. We estimate that MCI will lose approximately 25 bps of share annually to the RBOCs in this segment, causing an estimated 100 bp drag to commercial revenue growth. Collectively, the “Drag Revenues” comprise 46% of 2003 revenues and are expected to decline 2% over time, while the “Growth Revenues” comprise 54% and grow 5%.

Figure 15: MCI Segment Exposure & Outlook Highlights

Revenue: $ Bil	**2003**	**2004**	**2005**	**2006**	**2010**	**'03 to '10 CAGR**
"Drag Segments"						
Consumer	**$6.3**	**$5.7**	**$5.3**	**$5.1**	**$4.5**	**-4.7%**
% Growth	-27.9%	-9.1%	-7.2%	-4.4%	-2.1%	
% of Consolidated Revs	26%	24%	22%	20%	16%	
SME	**$5.0**	**$4.8**	**$4.8**	**$4.9**	**$5.3**	**0.7%**
% Growth	-10.1%	-3.9%	0.3%	1.5%	1.8%	
% of Consolidated Revs	21%	20%	20%	20%	19%	
Total "Drag Segments" (Cons+SME)	**$11.3**	**$10.6**	**$10.2**	**$10.0**	**$9.8**	**-2.1%**
% Growth	-20.9%	-6.8%	-3.8%	-1.6%	0.0%	
% of Consolidated Revs	46%	44%	42%	40%	34%	
"Growth Segments"						
Wholesale & Large Enterprise	**$13.1**	**$13.5**	**$14.3**	**$15.2**	**$18.8**	**5.3%**
% Growth	-11.8%	2.7%	6.1%	6.2%	4.9%	
% of Consolidated Revs	54%	56%	58%	60%	66%	
MCI Consolidated Revenue	**$24.5**	**$24.0**	**$24.5**	**$25.2**	**$28.6**	**2.3%**
% Growth	-16.3%	-1.7%	1.8%	3.0%	3.2%	

EBITDA: $ Bil	**2003**	**2004**	**2005**	**2006**	**2010**	**'03 to '10 CAGR**
"Drag Segments"						
Consumer	**$0.7**	**$0.6**	**$0.5**	**$0.4**	**$0.2**	**-16.1%**
% Growth	-53.1%	-9.4%	-18.5%	-15.5%	-15.9%	
% of Consolidated EBITDA	25%	18%	13%	10%	4%	
Margin	11.0%	11.0%	9.7%	8.5%	4.5%	
SME	**$0.8**	**$0.9**	**$1.0**	**$1.0**	**$1.2**	**6.1%**
% Growth		12.1%	8.6%	5.2%	4.0%	
% of Consolidated EBITDA	30%	26%	25%	24%	22%	
Margin	16.2%	18.8%	20.4%	21.2%	23.3%	
Total "Drag Segments" (Cons+SME)	**$1.5**	**$1.5**	**$1.5**	**$1.5**	**$1.4**	**-0.7%**
% Growth		2.2%	-2.5%	-1.9%	0.6%	
% of Consolidated EBITDA	55%	45%	38%	34%	25%	
Margin	13.3%	14.6%	14.8%	14.7%	14.7%	
"Growth Segments"						
Wholesale & Large Enterprise	**$1.2**	**$1.9**	**$2.5**	**$2.9**	**$4.3**	**19.6%**
% Growth		55.9%	28.8%	16.9%	8.3%	
% of Consolidated EBITDA	45%	55%	62%	66%	75%	
Margin	9.3%	14.1%	17.2%	18.9%	22.8%	
MCI Consolidated EBITDA	**$2.7**	**$3.4**	**$4.0**	**$4.3**	**$5.7**	**11.1%**
% Growth	-45.6%	26.2%	14.8%	9.8%	6.2%	

Core Products and Competitors:
As shown in the following table, MCI maintains strong product positions across the Enterprise space, but particularly strong positions within the retail Large Enterprise market, a market totaling an estimated $50 billion in 2003 and representing about 33% of the total Enterprise market. In long distance voice, MCI is the second-largest US carrier, behind AT&T; when including local voice revenues, MCI's estimated share position is 6th. Across the legacy data products such as private line, FR, and ATM, MCI generally maintains the second market share position. Historically, MCI held a lead in Large Enterprise DIA, but we believe the disruption of the past few years, both in terms of its client base being particularly hard hit from the Internet crash, as well as the company's own bankruptcy filing, has pushed AT&T into the lead spot in this product. Conversely, this decline leads to opportunity going forward. We believe network overhauls to migrate toward a single IP core as well as intense sales focus within Large Enterprise will drive faster-than-industry growth for MCI in these core products, with IP-LAN/WAN driven products such as IP-VPNs and MPLS-enable services leading the way

Figure 16: The Core MCI Products and Competitors

Core MCI Wholesale-Focused Markets & 2003 Estimated Sizes - $31.0 b

	Voice - $13.8 b		**DIA - $3.6 b**		**Dial & DSL Wholesale - $2.0 b**
1	**AT&T**	**1**	**Sprint**	**1**	**Level 3**
2	**MCI**	**2**	**Level 3**	**2**	**MCI**
3	**Qwest**	**3**	**MCI**	**3**	**Sprint**
4	**Sprint**	4	AT&T	4	Qwest
5	RBOCs	5	Qwest	5	Regional Players

Core MCI Retail-Focused Markets & 2003 Estimated Sizes - 121.0 b*

	Voice - $55.7 b		**Packet Svcs(1) - $26.0 b**		**Private Line: Retail(2) - $16.0 b**
1	**SBC**	**1**	**AT&T**	**1**	**AT&T**
2	**AT&T**	**2**	**MCI**	**2**	**MCI**
3	**Verizon**	3	Sprint	**3**	**RBOCs**
4	**Sprint**	4	Qwest	4	Sprint
5	**BellSouth**	5	RBOCs (in-region)	5	Network Carriers
6	**MCI**		(1) FR, ATM & IP LANs, WANs and VPNs		(2) DS-3 & below; market includes ILEC/IXC last-mile links since most end-users are retail-based
7	**Qwest**				

	DIA - $4.6 b		**Managed Svcs(3) - $9.0 b**		**Network Integration(5) - $18.5 b**
1	**AT&T**	**1**	**AT&T**	**1**	**Network Integrators(6)**
2	**MCI**	**2**	**Network Integrators(4)**	**2**	**AT&T**
3	Qwest	3	Qwest	3	Regional/Other Consultants
4	Network Carriers	4	MCI	4	RBOCs
5	Regional Players	5	RBOCs		(5) Includes outsourced network design and integration
			(3) Includes network management outsourcing fees, hosting, e-services & colocation revenue.		(6) The large network design integrators such as IBM, EDS & others.
			(4) The large network design integrators such as IBM, EDS & others.		

* $130 b of gross Retail Large Enterprise & SME revenues less $9 b of intercarrier eliminations
Bold = A dominant market share position

Competitive Advantages:
MCI's core competencies are anchored by its top-tier market share position and reputation within Large Enterprise, its rejuvenated balance sheet and its product mix, which has the heaviest weighting in favor of data revenues of any incumbent carrier. MCI has established itself, in conjunction with AT&T, as one half of the dominant "duopoly" in terms of the retail Large Enterprise telecom services market. The merging of WorldCom and its leading Internet business, UUNet, with MCI's corporate customer list pushed the company to years of accelerated growth, as it was successful in penetrating the old MCI commercial customers with increasing amounts of IP-centric products. While the Internet downturn was particularly impactful to UUNet, which had a heavier than average exposure Internet-centric companies, we believe MCI's established reputation and corporate customer list will continue to be its number one competitive advantage, with the share loss of the last two years ironically providing upside opportunity over the next several years. Additionally, thanks to the fresh-start procedures of bankruptcy, MCI is eliminating more than $28 billion in term debt, leaving it with only $4.7-$5.7 billion of total debt at re-emergence, and only $2.5-$3.5 billion of net debt. This leaves its estimated 2004 leverage at only 0.7x net debt/EBITDA and its interest coverage at 3.4x (somewhat lower than AT&T's due to MCI's lower margins). This increased slack should give the company more flexibility to invest capital in efficiency-improving areas. Finally, MCI maintains a revenue mix that is easily the most data-weighted among the incumbent carriers. We estimate that 53% of its 2004 revenues will be data/IP, versus an industry average of 45%, and AT&T's weighting of 40%. We believe this weighting differential alone gives MCI an average 100 bp total revenue growth advantage versus AT&T.

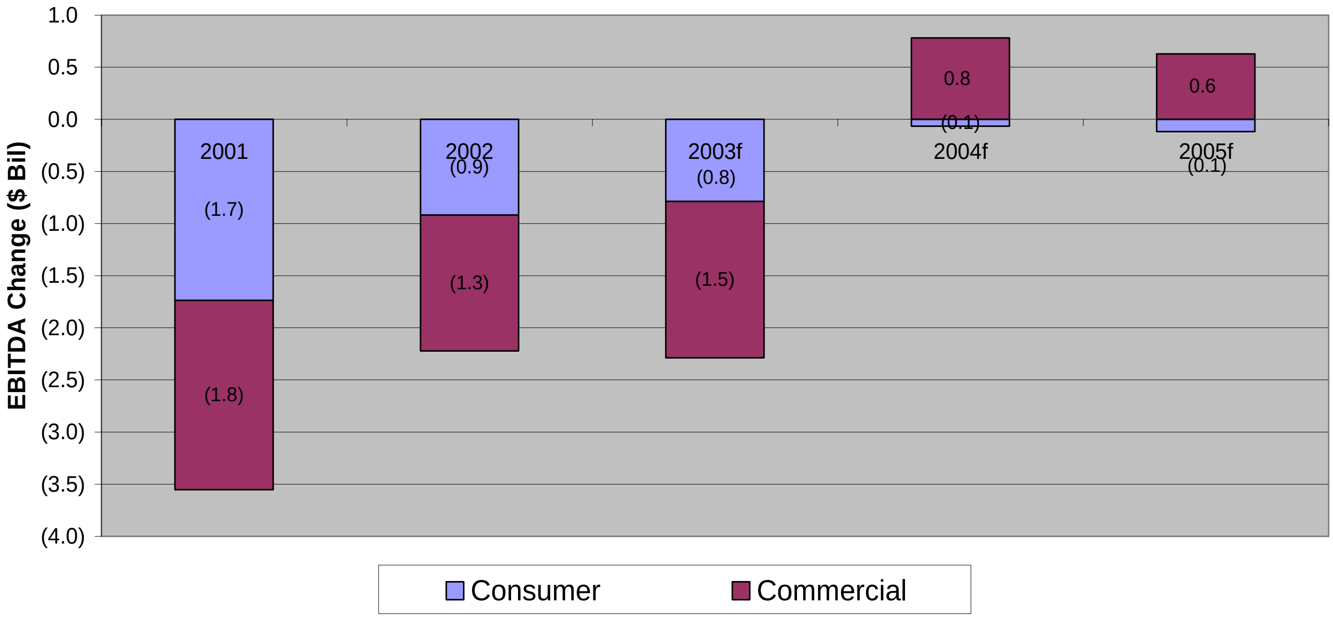
Figure 17: Competitive Advantage – Product Mix Favors Data

Mix Weighted in Favor of Data			
2004f Revenues ($ Bil):	**MCI Commercial Serv.**	**Enterprise Coverage Group Average**	**MCI Mix Vs. Enterprise Group Average**
Voice	**$5.3**	**$24.3**	
Growth	-5.3%	-3.9%	
% of Total	**29%**	**44%**	**-1500 bp**
Data	**$9.7**	**$24.8**	
Growth	3.8%	3.2%	
% of Total	**53%**	**45%**	**800 bp**
Other (Inc. Intl)	$3.3	$6.0	
Growth	2.9%	-1.3%	
% of Total	18%	11%	
Total	**$18.3**	**$55.1**	
Growth	0.8%	-0.6%	

Competitive Challenges:
MCI is facing a number of challenges as it re-emerges from bankruptcy, including low margins (large cost structure and low pricing), continuing drag from its Consumer unit and some technical volatility that is likely to impact the stock upon initial trading. We believe MCI's low margins are driven by a combination of lower pricing and the myriad networks, systems and hierarchical infrastructure built up from its acquisition process over the years. MCI has historically operated as a holding company that overseas the numerous autonomous companies it has acquired since the 1980s. This has helped lead to the lower margins it maintains versus it peers, due to the layers of inefficient legacy systems, redundancies and parallel network protocols inherent in this structure. Additionally, MCI faces ongoing drag from its Consumer unit as it suffers under technological substitution losses to wireless and Internet, as well as competitive losses to RBOCs. Over the past two years, despite the fact that Consumer is only approximately 25% of revenues, it has accounted for approximately 45% of total EBITDA declines (shown in the following figure). We expect ongoing declines in this unit, estimated at 5% annual revenue declines over the long run, and 16% annual EBITDA declines. Additionally, we estimate that due to its broader deployment of UNE-P, the margins on its local product are lower, and will take longer to reach breakeven than AT&T's.

Finally, we expect there to be technical volatility in both the when-issued share price, as well as the initial exchange trading of the stock due to issues of dilution-concern and ownership redistribution from restructuring (credit) investors into new equity investors.

Figure 18: Competitive Challenge – Consumer Drag

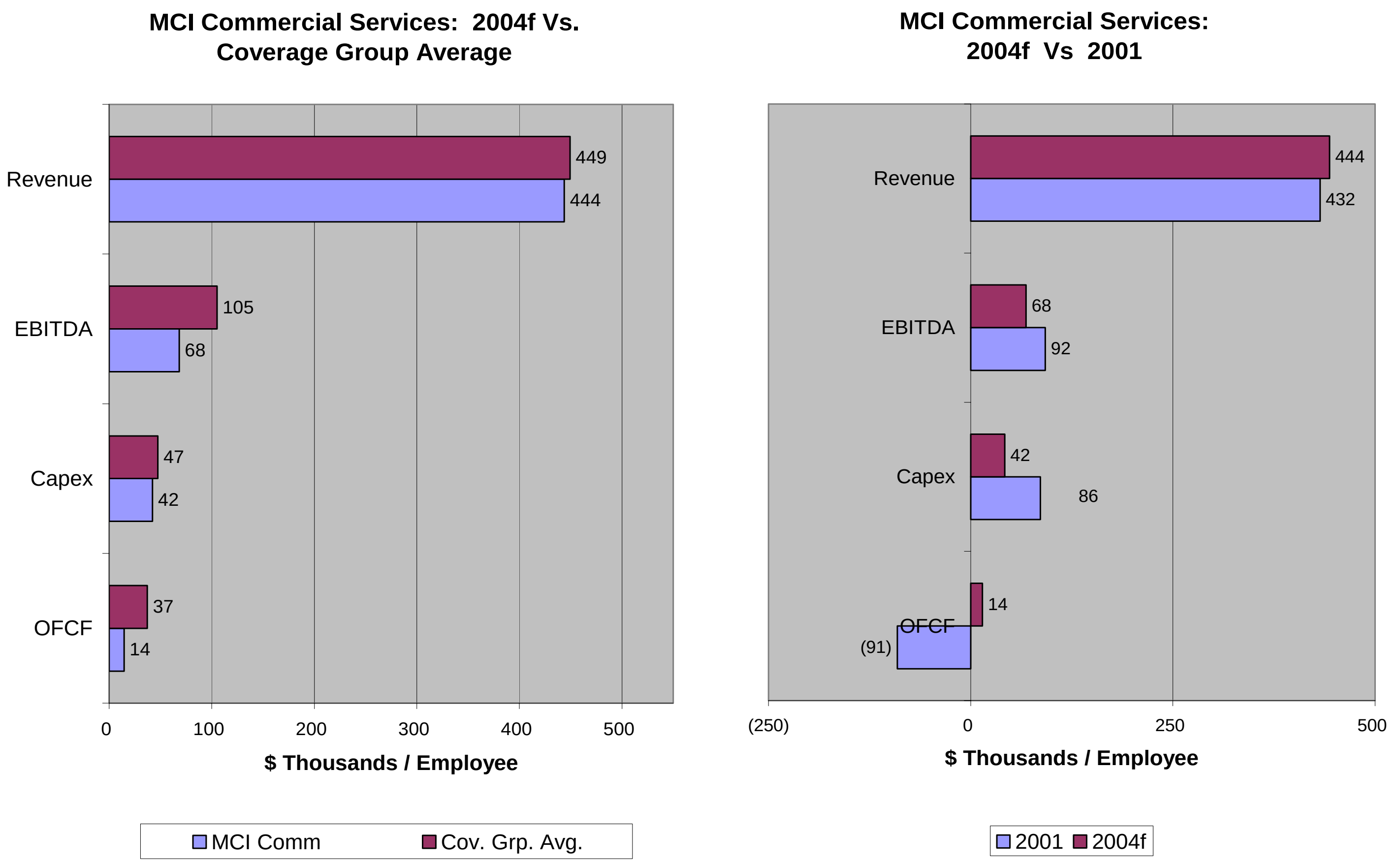


While MCI's low margins represent a current disadvantage, costs are one thing that management can truly control. Therefore, we believe this actually represents tremendous upside for the company – the key will be management's dedication to *ongoing* margin improvements. The drag from Consumer revenue declines is more problematic, but we believe MCI benefits from a lower proportion of fixed costs within its Consumer unit, which should allow the company to better eliminate expenses as volumes decline, allowing cashflows to remain positive strategically, albeit at very low margins. This is highlighted by the fact that we estimate that SG&A as a percent of revenues in 2003 is 33% for MCI, but 43% at AT&T.

Network:
MCI owns and operates an estimated 75,000 global route-mile (ex-undersea), IP-MPLS over DWDM at the core fiber backbone reaching an estimated 4,500 IP POPs in 130 markets in 65 countries worldwide. It represents one of the most extensive networks in the US and claims the most dial IP modems of any US carrier (3.2 million). Management is aggressively overhauling the legacy components of this network, consolidating its protocols to a single IP core and deploying MPLS switching throughout as part of its initiative to improve network efficiency and performance, and lower costs. This initiative will allow MCI to significantly reduce its estimated 400+ total systems as well as eliminate redundant overlay networks and consolidate all traffic (including voice) to a single IP core. Management intends to migrate approximately 25% of its voice traffic to this core by the end of 2004, leaving it somewhat behind incumbent competition, which spending the bulk of their 2003 capital budget to begin a migration of traffic to a single packet-switched core this year. We believe this “lost year” in terms of capital spending as a result of the bankruptcy process is the likely to be the largest friction to the company as it recovers from its financial distress. Having said that, MCI’s market share, reputation and scale provide strong assets to carry it while such efficiencies are achieved, and we believe there are material opportunities for improved cashflows deriving from such improvements.

Productivity and Efficiency:
MCI is estimated to lag the Enterprise industry in most operating metrics, but particularly in EBITDA per employee. At a 2004 forecast of $68k EBITDA/employee, MCI lags the industry average of $105k by 35% and the AT&T level of $141k by more than 50%. We believe this is driven by a combination of lower pricing and a redundant cost structure accumulated through multiple acquisitions. However management is keenly focused on achieving 500 bps+ of margin improvement by 2005 (MCI lags the industry by as much as 1,000 bps), which we believe is achievable given the magnitude of opportunity for improvement, the network and systems overhaul and hierarchical restructuring taking place.

Figure 89: Operating Metrics Per Employee



OFCF is defined as CFFO - Capex; All metrics reflect commercial telecom services operating information divided by estimated commercial telecom services employees.

Capital Structure and Financial Strength:
MCI should re-emerge from bankruptcy with 326-366 million shares of new equity and $4.5-$5.5 billion in new senior term debt (plus $275 million in capitalized leases). Of the 15 classes of claimants to MCI's assets, five can or will be receiving equity in the newly reorganized company, including the following classes:

	Est. Claim Amount ($ bil)
■ Class 5 WorldCom Senior Debt Claims	$27.3
■ Class 6 WorldCom General Unsecured Claims	n/a
■ Class 11 Intermedia Senior Debt Claims	$0.9
■ Class 12 Intermedia General Unsecured Claims	n/a
■ Class 13 Intermedia Subordinated Debt Claims	$0.3

Of these classes, we estimate that Class 5, the WorldCom Senior Debt Claims, will receive nearly 90% of the new stock, with Class 11 receiving approximately 8%, with the balance spread among the rest, representing 100% equity ownership of the company at the moment of reorganization. However, management has established a restricted stock and options program through which shares and options on shares will be distributed, diluting the re-emergence owners over time. Our analysis makes no assumptions or estimations regarding such dilution from restricted stock or options. We have assumed the bankruptcy plan capital structure of 326 million in new equity shares, valued at $25 per share, to yield an initial $7.2 billion market cap, and $5.7 billion of total debt ($3.5 billion in net debt), resulting in an initial enterprise value of $11.6 billion. This represents a 4.4x multiple of our 2003 MCI EBITDA forecast and 3.4x multiple of our 2004 forecast, which is in-line with current trading levels of AT&T). The following table highlights various potential prices and implied EV/EBITDA multiples.

Figure 20: MCI Stock Price & Implied EBITDA Multiples

		EBITDA & Multiples			
Assumed NewCo	NewCo Total	2003	2004		
Share Price	Enterprise Value	$2,731	$3,250	$3,448	$3,690
$22.50	10,772.7	3.9x	3.3x	3.1x	2.9x
$23.00	10,935.7	4.0x	3.4x	3.2x	3.0x
$23.50	11,098.7	4.1x	3.4x	3.2x	3.0x
$24.00	11,261.7	4.1x	3.5x	3.3x	3.1x
$24.50	11,424.7	4.2x	3.5x	3.3x	3.1x
$25.00	**11,587.7**	**4.2x**	**3.6x**	**3.4x**	**3.1x**
$25.50	11,750.7	4.3x	3.6x	3.4x	3.2x
$26.00	11,913.7	4.4x	3.7x	3.5x	3.2x
$26.50	12,076.7	4.4x	3.7x	3.5x	3.3x
$27.00	12,239.7	4.5x	3.8x	3.5x	3.3x
$27.50	12,402.7	4.5x	3.8x	3.6x	3.4x
$28.00	12,565.7	4.6x	3.9x	3.6x	3.4x

At our base case assumptions of the maximum debt and minimum equity ($5.7 billion in debt and 326 million equity shares), MCI will still boast one of the best balance sheets in the business. The following table highlights this strength. At re-emergence, we expect MCI to have leverage of 1.3x (net debt/EBITDA). With expected improvements in 2004 EBITDA, we expect leverage to fall to 0.7x and interest coverage to be 3.4x. This financial slack should give MCI the flexibility to invest capital in efficiency-improving areas.

Figure 21: MCI Capital Structure Outlook – Pre & Post Restructuring

MCI Capital Structure & Cashflow Outlook: 2003 Pre & Post Reorg. & Forecasts

	2003		Proforma Projections - Reorganized Company					
($ bil):	Pre-Reorg.	Reorganized Company	2004	2005	2006	2007	2008	2009
Cash Balance	$4.7	$2.3	$3.1	$4.2	$5.1	$6.1	$7.2	$8.3
Total Assets	$20.0	$20.9	$21.8	$23.1	$24.5	$26.2	$28.0	$30.0
Total Debt	$34.2	$5.7	$5.6	$5.5	$5.5	$5.5	$5.5	$5.5
Net Debt (Net of Adjustments)	$29.4	$3.4	$2.5	$1.3	$0.4	($0.6)	($1.7)	($2.8)
Debt Mat./Paid-down this Period[1]		$28.4	$0.1	$0.1	$0.0	$0.0	$0.0	$0.0
OFCF[2]		$2.2	$1.0	$1.2	$0.9	$1.0	$1.1	$1.1
Total Incremental Financing Required		$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Portion Assumed as Debt		$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Portion Assumed as Equity		$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0
Leverage (Net Debt / EBITDA)	10.3x	1.3x	0.7x	0.3x	0.1x	-0.1x	-0.3x	-0.5x
Coverage (Unlev. OFCF /Cash Int.)	not paying coupons in '03		3.4x	4.0x	3.5x	3.8x	4.1x	4.3x

Comments — Represents the least levered, large-cap telecom services company

(1) 2003 debt reduction represents the debt forgiven as part of fresh start accounting under Chapter 11.

(2) Operating Free Cash Flow is defined as CFFO - capex.

MCI as a Consolidation Play?

Upon re-emergence from bankruptcy, MCI will present itself as an extremely attractive commercial telecom services company, with minimal debt, strong coverage ratios and the second-leading market share among the Enterprise carriers, but slowed by a high cost structure and a consumer unit that is in sharp decline. If a potential suitor could solve the consumer overhang by somehow selling off the consumers that are out of the suitor's local footprint (if it has any), and get comfortable with its ability to materially rationalize MCI's commercial cost structure, MCI could be attractive at its estimated $10-$12 billion valuation upon re-emergence. There is significant execution risk however in such a transaction, as paring off the unwanted portions of the consumer arm could be highly complex, require extensive regulatory approvals, receive very low valuations and take a long time.

Additionally, the only deal structures that are likely to receive regulatory approval are the ones that are the most economically unattractive. For example, in order for an RBOC to win regulatory approval for an MCI acquisition, it would likely have to divest the consumer business in-region (which would be the only customers the RBOC would want to keep to begin with) and agree to do one of the following: (1) operate MCI's consumer long distance and local UNE-P business out of region, or (2) sell it intact to another company that would. All of this makes for an especially messy transaction with unattractive economics. The only consumers that are efficient for an RBOC to keep would be the in-region ones, which they'd have to divest. And the out of region ones, served with low-margin UNE-P would be extremely unattractive and dilutive. Additionally, we do not see many other buyers out there that would be interested in owning and operating the consumer business – there simply aren't enough local customers for it to make sense for a cable company to buy (and the cable companies would likely have the same incentives to divest the out-of-footprint consumers and keep the in-footprint ones, again flying exactly in the opposite direction of what would likely gain regulatory approval). In our opinion, all of this makes an acquisition unlikely in the near term.

Business Units and Forecasts:
As the following table shows, we believe that 2004 will mark the last consolidated revenue decline for MCI as it pulls itself out of bankruptcy and the economy stabilizes and begins to improve. We expect total revenues to decline approximately 1.7% in 2004, but EBITDA to grow a material 26%+, driven by the significant cost reduction efforts discussed previously and the forecast 310 bp improvement in EBITDA margins. Operating free cashflow declines are also expected to bottom out in 2004 at around $1 billion, and then grow approximately $100-200 million per year. As the Commercial unit refocuses its efforts on regaining profitable market share, and demand begins at least a modest recovery, we expect consolidated revenue growth to approach the 2-3% range. However, we believe EBITDA can grow at more healthy rates due to the significant cost reduction opportunities and management's intense focus in this area – we expect to see consolidated EBITDA grow approximately 11% annually through 2010.

Figure 22: MCI Consolidated Summary Forecasts

($ Bil)	2001	2002	2003f	2004f	2005f	2010	'03 to '10 CAGR
Commercial (Inc. Intl)	$22.7	$20.5	$18.2	$18.3	$19.1	$24.1	4.1%
% Growth	4.8%	-9.7%	-11.4%	0.8%	4.6%	4.2%	
Consumer	$11.2	$8.7	$6.3	$5.7	$5.3	$4.5	-4.7%
% Growth	-13.6%	-21.8%	-27.9%	-9.1%	-7.2%	-2.1%	
Corp.	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0	#DIV/0!
Total Revenue	**$33.9**	**$29.2**	**$24.5**	**$24.0**	**$24.5**	**$28.6**	**2.3%**
% Growth	-2.1%	-13.7%	-16.3%	-1.7%	1.8%	2.4%	
EBITDA	**$7.2**	**$5.0**	**$2.7**	**$3.4**	**$4.0**	**$5.7**	**11.1%**
% Growth	-32.9%	-30.7%	-45.6%	26.2%	14.8%	6.2%	
Margin	21.4%	17.2%	11.2%	14.3%	16.2%	20.0%	
Operating Income	**$5.5**	**$3.4**	**$1.3**	**$1.8**	**$2.1**	**$3.5**	**15.8%**
% Growth	-41.8%	-38.2%	-62.9%	40.8%	18.3%	8.6%	
Margin	16.4%	11.7%	5.2%	7.4%	8.7%	12.4%	
Net Income	**$2.7**	**$1.5**	**$1.2**	**$0.9**	**$1.1**	**$2.0**	**7.9%**
% Growth	-49.3%	-42.2%	-25.0%	-24.6%	24.6%	10.2%	
Margin	7.9%	5.3%	4.7%	3.6%	4.4%	6.9%	
Capex	**$4.8**	**$1.5**	**$1.2**	**$1.8**	**$2.0**	**$2.8**	**13.1%**
% Growth	-30.3%	-69.5%	-18.6%	48.9%	13.7%	5.1%	
% of Rev	14.1%	5.0%	4.9%	7.4%	8.2%	9.8%	
OFCF(1)	**($5.3)**	**$3.4**	**$2.2**	**$1.0**	**$1.2**	**$1.1**	**-9.3%**
% Growth		-163.7%	-35.0%	-53.7%	17.0%	1.9%	
Margin	-15.6%	11.5%	9.0%	4.2%	4.9%	3.9%	

(1) Operating Free Cash Flow is defined as CFFO - capex.

Commercial:

We believe the ability for MCI management to strip away significant cost structure is the most important value driver for the company over the next 1-2 years. In this regard, given its importance, the vast opportunity (MCI Commercial's estimated margins lag the industry by 1,000 bps and AT&T's by as much as 1,500 bps), and management's focus and current initiatives, we believe MCI - Commercial will be successful in driving more than 680 bps of EBITDA margin improvement over the next 2 years, with approximately 420 bps of this coming in 2004 and 260 bps in 2005. This would still leave MCI Commercial's estimated EBITDA margins at only 18% in 2005, which would still represent a 450 bp disadvantage versus the industry forecast and a 1,000 bp discount to AT&T Business Services' margins. A key question in forecasting margin improvements of this magnitude is pricing. As we've discussed earlier, given the already slim margins at the company, we believe aggressive across-the-board price cuts are not in store, but would clearly wipe out forecasted margin improvements if they were to occur.

The following table summarizes our Commercial forecasts, which are characterized by recovering but still-moderate revenue growth and but sharply improving margins and EBITDA. Commercial revenues are expected grow 0.8% in 2004, driven by 4% growth in data revenues, moderated by a 3% decline in voice revenues. We expect EBITDA to grow 38% in 2004 as margins are expected to improve by approximately 420 bps. We believe 2004 should also mark the low-mark in terms of OFCF at approximately $0.6 billion, which should begin healthy growth from that point forward. Strategically, we expect the Commercial unit will grow revenues 4% annually, due to a greater weighting of data revenues (53% of 2003 MCI Commercial revenues versus an industry average of 45%) and market share recapture-opportunities within Large Enterprise. With ongoing improvements in margins, back toward the low end of industry averages, we believe EBITDA will grow 15% annually, on average, through 2010.

Figure 23: MCI Commercial Summary Forecasts

($ Bil)	2001	2002	2003f	2004f	2005f	2010	'03 to '10 CAGR
Total Voice	$7.9	$6.6	$5.6	$5.3	$5.3	$5.7	0.3%
% Growth	-16.0%	-17.1%	-15.0%	-5.3%	-0.8%	1.9%	
Data & IP	$11.8	$10.4	$9.4	$9.7	$10.4	$14.3	6.2%
	19.6%	-11.6%	-10.1%	3.8%	7.6%	5.4%	
Other	$3.0	$3.5	$3.2	$3.3	$3.4	$4.1	3.7%
Total Revenue	**$22.7**	**$20.5**	**$18.2**	**$18.3**	**$19.1**	**$24.1**	**4.1%**
% Growth	4.8%	-9.7%	-11.4%	0.8%	4.6%	4.2%	
EBITDA	**$4.8**	**$3.5**	**$2.0**	**$2.8**	**$3.4**	**$5.5**	**15.3%**
% Growth	-27.3%	-26.9%	-42.4%	38.4%	22.3%	7.3%	
Margin	21.3%	17.3%	11.2%	15.4%	18.0%	22.9%	
Capex	**$4.5**	**$1.4**	**$1.1**	**$1.7**	**$1.9**	**$2.7**	**13.3%**
% Growth	-27.9%	-69.9%	-18.5%	57.1%	10.1%	9.2%	
% of Rev	19.9%	6.6%	6.1%	9.5%	10.0%	11.0%	
OFCF(1)	**($4.8)**	**$1.7**	**$1.3**	**$0.6**	**$0.9**	**$1.2**	**-1.5%**
% Growth	129.8%	-136.7%	-26.4%	-53.5%	50.9%	-2.8%	
Margin	-21.0%	8.5%	7.1%	3.3%	4.7%	4.8%	

(1) Operating Free Cash Flow is defined as CFFO - capex.

Consumer:

MCI faces ongoing drag from its Consumer unit as it faces technological substitution losses to wireless and Internet, as well as competitive losses to RBOCs. Over the past two years, despite the fact that Consumer is only approximately 25% of revenues, it has accounted for approximately 45% of total EBITDA declines. We expect ongoing declines in this unit, estimated at 5% annual revenue declines over the long run, and 16% annual EBITDA declines. Additionally, we estimate that due to its broader deployment of UNE-P, the margins on its local product are lower, and will take longer to reach breakeven than AT&T's. For example, we believe MCI's 2003 local UNE-P EBITDA margins are -30%, while AT&T's are -26%. This should improve over the next several years, but at slow rates and with limited profit potential. On the plus side, we believe MCI benefits from a lower proportion of fixed costs within its Consumer unit, which should allow the company to better eliminate expenses as volumes decline, allowing cashflows to remain positive strategically, albeit at very low margins. This is highlighted by the fact that we estimate that SG&A as a percent of Consumer revenues in 2003 is 33% for MCI, but 43% at AT&T. We summarize our MCI local UNE-P forecasts in a subsequent table.

The following table summarizes our Consumer forecast, which is characterized by 7-9% annual revenue declines losses through 2005, easing to mid-single single digit declines longer-term as wireless substitution matures, RBOC penetration slows, voice-rate declines ease, and UNE-P local bundling helps boost customer retention. On average, we are expecting revenues to decline nearly 5% annually through 2010, with EBITDA staying positive throughout. Ultimately, the Consumer unit should shrink to a size that is small relative to the Commercial arm, such that its ultimate resolution would not have dramatic effects. The challenge for MCI in the interim is to build wholesale replacements for the network volume that Consumer currently uses, which should be aided by a gradual migration of voice to VoIP.

Figure 24: MCI Consumer Summary Forecasts

($ Bil)	2001	2002	2003f	2004f	2005f	2010	'03 to '10 CAGR
Stand-Alone LD Voice	$7.1	$5.0	$2.8	$1.5	$0.7	$0.1	-37.9%
% Growth	2.1%	-29.3%	-43.2%	-46.4%	-55.9%	n/m	
Bundled Voice	$0.2	$1.0	$2.4	$3.2	$3.9	$4.0	7.9%
	n/m	576.1%	125.6%	37.4%	18.5%	-1.8%	
Other	$4.0	$2.7	$1.1	$1.0	$0.8	$0.4	-14.5%
Total Revenue	**$11.2**	**$8.7**	**$6.3**	**$5.7**	**$5.3**	**$4.5**	**-4.7%**
% Growth	-13.6%	-21.8%	-27.9%	-9.1%	-7.2%	-2.1%	
EBITDA	**$2.4**	**$1.5**	**$0.7**	**$0.6**	**$0.5**	**$0.2**	**-16.1%**
% Growth	-42.0%	-38.2%	-53.1%	-9.4%	-18.5%	-15.9%	
Margin	21.5%	17.0%	11.0%	11.0%	9.7%	4.5%	
Capex	**$0.3**	**$0.1**	**$0.1**	**$0.0**	**$0.1**	**$0.2**	**10.1%**
% Growth							
% of Rev	2.4%	1.1%	1.3%	0.5%	1.8%	3.5%	
OFCF(1)	**($0.5)**	**$1.6**	**$0.9**	**$0.4**	**$0.3**	**($0.0)**	**-165.7%**
% Growth		-402.6%	-44.2%	-53.8%	-31.3%	n/m	
Margin	-4.8%	18.6%	14.4%	7.3%	5.4%	-1.1%	

(1) Operating Free Cash Flow is defined as CFFO - capex.

Figure 25: MCI Consumer Local UNE-P Forecasts

MCI Consumer - Stand-Alone Local UNE-P Forecasts				
Subscribers: (000)	**2003f**	**2004f**	**2005f**	**2006f**
Eligible Consumer HHs	**96,513**	**93,394**	**92,221**	**91,396**
% of US	78.0%	85.0%	85.0%	85.0%
Gross Adds	3,496	3,829	3,704	3,574
- Churn (Annual)	50.2%	47.2%	39.6%	37.4%
Net Adds	**2,041**	**1,496**	**1,153**	**733**
Year-End Subs	**4,941**	**6,437**	**7,590**	**8,322**
Penetration of Eligible HHs	5.1%	6.9%	8.2%	9.1%
Revenue:				
Effective ARPU/Mo.	**$29.6**	**$28.2**	**$27.6**	**$27.6**
Local UNE-P Revenue ($mil)	**$1,411**	**$1,941**	**$2,333**	**$2,646**
% Growth	115%	38%	20%	13%
Expenses:				
CGS: UNE-P Rate/Sub/Mo.	$18.2	$19.0	$19.3	$19.3
Gross Margin	38%	32%	30%	30%
SG&A (Inc. Acq. Costs)/Sub/Mo.	$20.7	$13.4	$9.7	$8.0
EBITDA ($mil)	**($419)**	**($273)**	**($107)**	**$36**
Margin	-30%	-14%	-5%	1%

Valuation – Bankruptcy Plan Capital Structure:
We have assumed the bankruptcy plan base-case capital structure of 326 million in new equity shares and $5.7 billion of total debt ($3.5 billion of 2003 net debt). The following table summarizes our estimation of the impact of higher amounts of equity (and thus lower amounts of debt) in the initial capital structure. We estimate that for each incremental 20 million shares of equity issued at the time of reorganization, the dilution per share is estimated to be $0.50 Therefore, if the maximum amount of 366 million shares is issued, we believe the equity value whould be $1.0 less than if the minimum 326 million shares are issued. The table also shows that no matter what the ultimate blend of debt and equity are under the reorganized capital structure, the leverage of the company is extremely modest. Additionally, even under the maximum 366 million share scenario, the implied P/E on estimated 2004 EPS is still a modest 10.0x, below the 2004 industry average of 11.5x.

Figure 26: Capital Structure & Value Implications

MCI - Valuation & Balance Sheet Effects of Different Re-emergence Capital Structures					
	Bankruptcy Base Plan	Range of Bankruptcy Plan Debt Scenarios		Versus Bankruptcy Plan Base Case	
Debt Scenario ($ bil):	Maximum of Possible Debt	Mid-Range of Possible Debt	Lowest-End of Possible Debt	Mid-Range Vs. Base Case	Lowest-End Vs. Base Case
Total Assets	**$20.9**	**$20.9**	**$20.9**		
Total Debt	$5.7	$5.2	$4.7	($0.5)	($1.0)
Debt / Assets	**27.5%**	**25.1%**	**22.7%**	**-240 bp**	**-479 bp**
Book Equity	$8.4	$8.9	$9.4	$0.5	$1.0
Debt / Equity	**0.7x**	**0.6x**	**0.5x**	**-0.1x**	**-0.2x**
"New-Co." Shares (mil)	326	346	366	20.0	40.0
"New-Co." 2004 EPS	**$2.76**	**$2.64**	**$2.50**	**($0.12)**	**($0.26)**
Implied P/E (on Assumed $25 Price)	9.1x	9.5x	10.0x	0.4x	0.9x
Unlevered FCF / Share	$4.41	$4.15	$3.93	($0.25)	($0.48)
Implied $25 Share Price / FCF	5.7x	6.0x	6.4x	0.3x	0.7x
DCF- Value / "New-Co."Share	**$25.1**	**$24.6**	**$24.1**	**($0.5)**	**($1.0)**

(1) Consolidated tracking stock information reflecting the current capital structure for Sprint. Corp.

Potential Trading Range:
The following table outlines what we believe to be a potential trading range for the new stock, given three views on the company. Our Base Case assumes that the stock's value is viewed on a discounted cashflow, as well as on relative EV/EBITDA multiple basis, and that management is reasonably successful in achieving its stated EBITDA goals for 2004. At an assumed maximum number of 366 million new shares, we believe a Bull-Case premium valuation could be $27-$28. Our Bear Case analysis assumes that only a EV/EBITDA multiple valuation gets applied and that the 10-year industry low multiple value is assigned to a 2004 MCI EBITDA amount that is only 50% as improved as management forecasts. This results in a $22 value per share. We believe the near-term equilibrium range should be between these two points, roughly in the $24-$26 range.

Figure 27: Potential Trading Range

MCI Potential Trading Range Arguments

New MCI Equity Valuation:	Bear Case	Base Case	Bull Case
Market Assumptions	Stock gets valued at the10-yr low-tick of industry EV/EBITDA multiples and market believe 2004 MCI EBITDA will only improve 50% of mgmt's forecasted $1 billion amount. No intrinsic value (DCF) credit is given.	Stock gets valued both intrinsically and by peer EV/EBITDA target multiples. Market believes 2004 MCI EBITDA will achieve 80% of mgmt's fore-casted improvement, reaching $3.5 b.	Stock gets valued both intrinsically and by peer EV/EBITDA target multiples. Market believes 2004 MCI EBITDA will achieve 100% of mgmt's fore-casted improvement, reaching $3.7 b.
Valuation Metrics: $ Bil			
Intrinsic Value:			
DCF - Public Equity Value	**No Credit**	**$8.2**	**$8.2**
EV / EBITDA Valuations:			
10-yr Low Industry Multiple	3.0x		
Industry Target Multiple		3.4x	3.4x
2004 EBITDA	$3.2	$3.4	$3.7
Enterprise Value	$9.5	$11.8	$12.6
- Net Debt	$2.5	$2.5	$2.5
Equity Value	**$7.1**	**$9.3**	**$10.2**
Equity Value Per Share[(1)] at…			
326 million shares (lowest)	$22	$27	$28
346 million shares (mid-range)	$22	$27	$28
366 million shares (max)	**$22**	**$26**	**$27**

Assumes 366 million Shares:	Price Support	Mid-Range Equilibrium	Premium Multiples
Potential Trading Range:	**$22**	**$24 - $26**	**$27 - $28**

(1) Equity Value per Share represents an equal weighted average of the DCF and EV/EBITDA multiple values for the Base Case and the Bull Case. For the Bear Case it only represents the EV/EBITDA multiple value.

Enterprise Telecom Services Comparables:

Figure 28: Enterprise Carrier Comparables

Company & Enterprise Value

Stock Information				Enterprise Value					Investor Returns				
									Current Yields		Stock Performance: % Return		
Company	Ticker	Price	Shares Out	Mkt.Cap	Net Debt	Non-Con. Assets	Enter. Value	Book Equity	Div Yld	ROA	Week	Month	YTD
AT&T(1)	T	$19.08	789	15.1	8.5	0.0	23.6	13.6	5.0%	7.6%	1%	-5%	-27%
T Bus. Serv.(2)										4.6%			
MCI(1)	MCIAV	$25.26	326	8.2	3.4	0.0	11.7	8.4	0.0%	6.5%	1%	-5%	-27%
MCI Comm.(2)										3.6%			
Sprint(1)	FON	$15.22	903	13.7	0.0	0.0	13.8	13.3	3.3%	8.7%	-6%	-3%	5%
FON Comm.(2)										4.2%			
Level 3(1)	LVLT	$5.33	653	3.5	4.5	0.0	8.0	0.3	0.0%	-1.9%	-4%	-1%	9%
L3 Comm.(3)										-5.1%			
XO Comm.	XOCM	$5.30	95	0.5	0.2	0.0	0.7	0.5	0.0%	-6.6%	-2%	-1%	N/A
Time Warner	TWTC	$10.16	115	1.2	0.8	0.0	2.0	0.5	0.0%	-1.8%	-7%	-13%	382%
Enterprise Avg.(Largecap for Div & ROA)									2.8%	4.2%	-3%	-5%	68%
S&P 500 Avg.	SPX	$1,047									-1%	1%	19%

Operating Statistics

Stock Information		Revenue				EBITDA				EPS			
	LEH	2003		2004		2003		2004		2003		2004	
Company	Rating	$ Bil	% Gwth	$ Bil	% Gwth	$ Bil	Margin	$ Bil	Margin	$	% Gwth	$	% Gwth
AT&T(1)	1-OW	34.7	-8.1%	32.9	-5.4%	8.7	25.1%	7.9	24.0%	$2.28	-17.2%	$1.73	-24.3%
T Bus. Serv.(2)		25.2	-5.3%	24.5	-2.5%	6.8	26.9%	6.8	27.9%				
MCI(1)	NR	24.5	-16.3%	24.0	-1.7%	2.7	11.2%	3.4	14.3%	N/A	N/A	$2.76	N/A
MCI Comm.(2)		18.2	-11.4%	18.3	0.8%	2.0	11.2%	2.8	15.4%				
Sprint(1)	2-EW	14.1	-7.0%	13.8	-2.6%	4.4	31.1%	4.5	32.9%	$1.45	7.5%	$1.55	6.4%
FON Comm.(2)		9.3	-5.6%	9.3	-0.6%	2.5	26.8%	2.7	28.5%				
Level 3(1)	1-OW	3.6	26.6%	3.6	-1.2%	0.4	12.1%	0.6	16.4%	($1.18)	N/M	($0.98)	N/M
L3 Comm.(3)		1.6	2.9%	1.8	9.0%	0.4	27.3%	0.6	32.2%				
XO Comm.		1.2	-7.2%	1.2	6.7%	0.0	1.1%	0.0	1.8%	($1.28)	N/M	($1.08)	N/M
Time Warner		0.7	-7.0%	N/A	N/A	0.2	28.6%	N/A	N/A	($1.06)	N/M	($0.89)	N/M
Enterprise Ind.		151.6	-4.7%	154.8	2.1%	31.0	20.4%	32.9	21.3%				

Valuation Multiples & Capital Structure

Stock Information		EV / Revenue		EV / EBITDA		EV / OFCF		P/E Ratio		Leverage Ratios		Coverage Ratios
	Price									Nt Debt /	Nt Debt /	Unlev. '04
Company	Target	2003	2004	2003	2004	2003	2004	2003	2004	Capital	'04 EBITDA	OFCF / Int.
AT&T(1)	$24	0.7x	0.7x	2.7x	3.0x	4.0x	6.9x	8.4x	11.1x	38.5%	1.1x	4.6x
T Bus. Serv.(2)		0.9x	1.0x	3.5x	3.4x	5.6x	8.4x					
MCI(1)	NR	0.5x	0.5x	4.3x	3.4x	5.3x	11.5x	N/A	9.2x	29.0%	1.0x	3.4x
MCI Comm.(2)		0.6x	0.6x	5.7x	4.1x	5.3x	11.5x					
Sprint(1)	$18	1.0x	1.0x	3.1x	3.0x	8.0x	6.9x	10.5x	9.8x	0.2%	0.0x	9.0x
FON Comm.(2)		1.5x	1.5x	5.5x	5.2x	12.8x	11.5x					
Level 3(1)	$7	2.2x	2.2x	18.2x	13.6x	N/A	115.1x	N/A	N/A	93.1%	7.7x	1.1x
L3 Comm.(3)		5.0x	4.5x	18.1x	14.1x							
XO Comm.		0.6x	0.5x	53.2x	30.0x	N/A	N/A	N/A	N/A	23.3%	7.4x	No Cash Int.
Time Warner		2.8x	N/A	9.8x	N/A	N/A	N/A	N/A	N/A	61.5%	N/A	N/A
Enterprise Avg.(Largecap)		0.7x	0.7x	3.4x	3.1x	5.8x	8.5x	9.4x	10.0x	22.6%	0.7x	5.7x
S&P 500 Avg.												

(1) Represents consolidated, total company information (for Level 3, reflects recurring items only - excludes any dark fiber, settlement & termination)
(2) Reflects operating statistics for the commercial portion of the company; valuation statistics reflect total company market valuation as a multiple of the commercial operating unit's cashflows.
(3) Refflects recurring Communications Group items only

APPENDIX 2

Telecom Services – Wireline

Anticipating Return to Business Growth

SECTOR VIEW

Rating: 1 - POSITIVE

Despite recent strong stock price performance in the Wireline Telecom Services group, we believe significant potential upside remains. We expect future outperformance will be driven by the Enterprise segment, where demand remains robust and a healthier pricing environment exists. We believe this bodes well for both the group's longer-term revenue outlook and, given the fixed-cost nature of telecom services, its earnings outlook as well. Consequently, we raised our wireline sector rating to 1-Positive from 2-Neutral.

- In our opinion, the telecom services stocks that have the most leverage to Enterprise trends are AT&T and—to a lesser degree—Verizon. With respect to the Emerging Telco names, we believe the robust demand environment should continue to support the group's growth multiples. Additionally, we believe M&A activity will likely remain brisk, enhancing the rationalization and bolstering valuations.
- We believe that, in evaluating the Telecom Services sector, overemphasis is placed on the consumer segment. At the end of the day, we estimate that AT&T and Verizon each have roughly 5% of their respective aggregate revenues exposed to cable voice competition.
- In our view, the Enterprise / Business segment is underanalyzed due to a myriad of factors, including post-bubble indifference, its opaque competitive structure, and the complexity of its sales cycle. Unlike Consumer—or even Wireless—the Enterprise segment cannot be easily understood with a simple P multiplied by a simple Q.
- Industry top-line growth has been flat during the last several years, despite significant volume growth, due to overcapacity, product cannibalization, and irrational pricing. Through 2010, we expect the Enterprise market will likely return to a growth level in the mid-single digits, despite continued declines in basic voice revenue.
- We believe the inflection is both a supply and a demand phenomenon. On the supply side, significant consolidation has resulted in a much more rational pricing environment. On the demand side, data traffic growth continues to be robust. Most industry experts we talked with agree that factors including organic traffic expansion, wireless backhaul, and some video applications are driving 40%–60% annual data volume growth.

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Analyst Certification

I, Thomas O. Seitz, hereby certify (1) that the views expressed in this research Industry Report accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Industry Report and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Industry Report.

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RBOC Summary

We believe the Telecom Services stocks that have the most leverage to Enterprise pricing stabilization are AT&T and, to a lesser degree, Verizon, whose consensus long-term revenue and earnings growth rates do not reflect this dynamic. As Figure 1 illustrates, while the RBOCs have had outsized stock price appreciation in 2006, in our view, AT&T and Verizon still do not appear expensive relative to the market. We believe the year-to-date stock price appreciation has been primarily driven by the realization of a rational competitive environment in the Consumer segment and abating skepticism surrounding merger synergies. Going forward, we expect that in the late 2007–2008 period, the revenue growth inflection for the RBOCs in the Enterprise segment, the basis of this report, will become apparent. We expect the management teams of the RBOCs to continue to emphasize this approaching phenomenon, which could lead to share appreciation in advance of the anticipated inflection.

We believe that the RBOCs have generally traded at a discount to the market (80%–90% of the SPX's forward P/E).

We believe that the RBOCs have generally traded at a discount to the market (80%–90% of the S&P 500's forward P/E) as 1) their earnings growth over the last several years has lagged the market, 2) any achieved earnings growth has typically been cost cut-related, and 3) the historical composition of their revenues was highly regulated. While 2007 earnings expansion will also likely be driven by expense synergies, by 2008, we believe that each of the RBOC revenue streams—Consumer, Wireless, and Business/Enterprise—will be growing. In our view, sustained earnings growth from the revenue side of the equation could drive multiple expansion. Consequently, we raised our price target on 1-Overweight-rated AT&T to $42 from $33 (for 31% total return potential). We believe that AT&T's earnings growth will likely outpace the rest of the RBOCs for the next three to five years and should be the bellwether for our thesis. We also raised our rating on Verizon to 1-Overweight from 2-Equal weight, and our price target to $41 from $37 (for 15% total return potential). While Verizon's earnings growth will likely lag that of AT&T because of fewer synergy opportunities and the dilution related to FiOS, we believe that the shares should benefit from the improved visibility we believe will occur in the Enterprise/Business segment. We would note that while a good case can be made that multiple expansion is warranted, our price targets are conservative and set only at the high end of historical trading ranges, suggesting further potential upside should our thesis on the Enterprise segment prove correct.

Figure 1: Current RBOC Valuations vs. the S&P 500

	Rating	Price on 10/27/06	Dividend Yield	EPS '06E	EPS '07E	'07 P/E	vs SPX	EPS CAGR '00-'05	EPS CAGR '06-'11
S&P 500 (SPX)		1,385.14	1.8%	84.14	89.14	15.5x	100%	9.3%	8.0%
AT&T (T)	1-OW	$ 34.30	3.9%	$2.31	$2.55	13.5x	87%	-5.4%	12.1%
BellSouth (BLS)	1-OW	38.85	4.5%	$2.34	na	na	na	0.1%	na
Qwest (Q)	2-EW	8.75	na	$0.25	$0.37	23.9x	154%	na	20.8%
Verizon (VZ)	1-OW	45.06	3.6%	$2.56	$2.65	17.0x	109%	-2.5%	9.5%

Source: Company reports, Lehman Brothers estimates and Bloomberg

Figure 2: New RBOC Price Targets and Potential Total Return

	Rating	Price on 10/27/06	YTD Total Return	Current Dividend	Dividend Yield	PT (YE07)	Potential Upside	Pot'l Total Return
S&P 500 (SPX)		1,385.14	10.8%	24.93	1.8%			
AT&T (T)	1-OW	$ 34.30	45.6%	$1.33	3.9%	$42.00	22.4%	26.3%
BellSouth (BLS)	1-OW	38.85	34.2%	$1.76	4.5%	$55.65	43.2%	47.8%
Qwest (Q)	2-EW	8.75	56.3%	$0.00	na	$8.00	-8.6%	-8.6%
Verizon (VZ)	1-OW	45.06	69.0%	$1.62	3.6%	$41.00	-9.0%	-5.4%

Source: Company reports, Lehman Brothers estimates and Bloomberg

Figure 3: New RBOC Price Targets Relative to the S&P 500's Current Valuation

	Current Price	Fwd Year EPS ('07E)	Current Fwd Year P/E	Current Fwd P/E vs SPX Fwd P/E
S&P 500 (SPX)	1,364.05	89.14	15.3x	
AT&T (T)	$33.06	$2.55	13.0x	85%
Verizon (VZ)	$36.59	$2.65	13.8x	90%
	YE07 Price Tgt	**Fwd Year EPS ('08E)**	**Target Fwd Year P/E**	**Tgt Fwd P/E vs Crnt SPX Fwd P/E**
AT&T (T)	$42.00	$3.00	14.0x	92%
Verizon (VZ)	$41.00	$2.87	14.3x	93%

Our YE07 price targets for T and VZ assume no multiple expansion for the S&P 500 and that both shares continue to trade at ~90% of the S&P 500 on forward year P/E basis

Source: Company reports, Lehman Brothers estimates and Bloomberg

Emerging Telco Summary – We Favor the "Towers" of Wireline Telecom

With respect to the Emerging Telco names, we believe that the robust demand environment we detail in this report should continue to support growth multiples for the group. Specifically, the shares of Time Warner Telecom and Cogent Communications Group currently trade at 0.27x and 0.12x 2007E EBITDA, respectively, on a growth-adjusted basis, which is a significant discount to the U.S. Cable group (0.82x). We believe TWTC and CCOI have significant potential upside to their shares.

We favor Emerging Telcos serving enterprises that possess a significant number of in-building Points of Presence (POPs), in addition to commoditized transport facilities.

Additionally, we believe the pace of M&A activity among the emerging telecom providers will likely remain brisk, enhancing the aforementioned rationalization and bolstering valuations. We favor Emerging Telcos serving enterprises that possess a significant number of in-building Points of Presence (POPs), in addition to commoditized transport facilities. We believe fiber-to-building POPs are somewhat analogous to tower assets in the Wireless space. As with a tower company, an adequate return on capital can be achieved by obtaining a single customer within an office building that has been wired with fiber. Material upside on revenue and margins can be realized by additional customers from that same building. In our view, these scarce assets could attract significant interest from backbone and non-RBOC affiliated wireless players.

Based on this thesis, we maintain our 1-Overweight rating on TWTC and have established a 2007 price target of $27, up from our 2006 price target of $20. We also raised our rating on CCOI to 1-Overweight from 2-Equal weight and established a 2007 price target of $17, up from our 2006 price target of $12. Please see our two related notes, "Time Warner Telecom: Best in Class Emerging Telco" (October 18, 2006), and "Cogent Communications Group: The Tower of Wireline Telecom" (October 18, 2006).

In addition, we maintain our 1-Overweight rating and $20 price target on Eschelon Telecom. We believe the company is a well-run CLEC and relatively cheap within the group. However, ESCH should trade at a discount to CCOI and TWTC, in our view, because the company lacks the operating leverage of a fiber-optic network that reaches all the way to the customer's premises.

Figure 4: Current Emerging Carrier Valuations

	Rating	Price on 10/27/06	YTD Total Return	Previous Price Target	New Price Target	Potential Upside	Current 2007 EBITDA Multiple	Target 2007 EBITDA Multiple	Est 2007 EBITDA Growth	Growth Adj EBITDA Multiple
Time Warner Telecom	1-OW	$ 20.05	103.6%	$ 20	$ 27	34.7%	10.4x	13.2x	38.3%	0.27x
Cogent	1-OW	14.73	168.3%	12	17	15.4%	16.5x	19.2x	123.4%	0.13x
Eschelon	1-OW	17.50	24.6%	20	20	14.3%	4.6x	6.1x	43.8%	0.11x
US Cable							8.6x		10.5%	0.82x

Source: Lehman Brothers estimates and Bloomberg

The Enterprise/Business Telecom Services Segment

We believe structural improvement in Business Services has accelerated rapidly over the last 24 months, primarily driven by consolidation.

In our view, the Enterprise/Business (we use the terms interchangeably throughout this report) segment of Telecom Services is underanalyzed due to a myriad of factors, including post-bubble indifference, its opaque competitive structure, and the complexity of its sales cycle. We believe the Business Services marketplace deserves a closer look from investors. We estimate the existing U.S. Wireline Telecom Services market represents a $200 billion revenue opportunity. Business Services, which represents roughly a $105 billion market, is more than 20% larger than the Consumer opportunity. In our view, structural improvement in Business Services has accelerated rapidly over the last 24 months, primarily driven by consolidation.

- The AT&T/SBC and VZ/MCI mergers have created two reinvigorated carriers in the Business Services market. Access cost and sales targeting synergies have allowed AT&T and Verizon to compete more effectively against carriers with lower cost structures.
- Sprint has scaled back its effort to serve business customers, and has concentrated its efforts on serving enterprises that represent large opportunities for its wireless business.
- Level 3 has embarked on a series of acquisitions in both the Transport and CLEC sectors that has absorbed significant amounts of excess capacity.

As a result of these activities, the often ruinous oversupply and pricing dynamics that plagued the business segment of Telecom Services have begun to subside. Although there continues to be downward price pressure, particularly on generic transport prices, the rate of decline has significantly slowed from 2000–2004 levels. While customers still expect more bandwidth or services per dollar spent when they renegotiate multi-year contracts, the competitive dynamic is evolving. Our sources suggest that fewer carriers are showing up for most RFPs, which creates opportunities for both the remaining national players as well as niche operators.

As a result, we believe the Business Telecom Services sector is entering the beginning stages of a revival, as providers sharpen their geographic focus and target specific customer segments. Both incumbent and emerging carrier strategies have changed during the past three to four years. In our view, they now coexist in ways that should lead to long-term success for the providers of business telecom services to both small and very large customers.

We divide the broadly defined Business Telecom Services into Voice, Data, and the considerably smaller Data Centers/Hosting. Within each category, the revenue potential for the various product categories varies significantly. Some of the more mature services, such as traditional voice and some data services—like Frame Relay and ATM—are shrinking; however, newer services like IP/VPNs, Metro Ethernet, and Hosting are growing rapidly. As illustrated in Figure 5 below, we believe aggregate Business Services revenue should grow in the low single digits (3%–4% CAGR), 4x faster than Consumer during the next four years. Over the same period, Data and Managed IP, which currently represent roughly one-half of Business segment revenues, will likely grow to represent more than 60% of the opportunity. Overall, we expect the Wireline Business Services market to reach approximately $120 billion, as Data and Managed IP growth outpaces Voice declines, and to represent three-fifths of the Wireline Telecom Services revenue opportunity by 2010.

Figure 5: Business Revenue and Product Trends

Telecom Services Revenue Opportunity

(Dollars in billions)	2004	2005	2006	2007	2008	2009	2010	2006-10 CAGR
Consumer	$ 83.4	$ 84.1	$ 85.2	$ 86.0	$ 86.8	$ 87.0	$ 87.1	0.7%
Business	101.6	102.1	103.7	106.5	109.7	113.5	118.2	3.0%
Wireless	109.7	122.0	134.5	143.5	149.8	154.7	158.1	5.3%
Total	$ 294.7	$ 308.2	$ 323.4	$ 335.9	$ 346.2	$ 355.3	$ 363.5	3.4%
% of total								
Consumer	28.3%	27.3%	26.3%	25.6%	25.1%	24.5%	24.0%	
Business	34.5%	33.1%	32.1%	31.7%	31.7%	32.0%	32.5%	
Wireless	37.2%	39.6%	41.6%	42.7%	43.3%	43.6%	43.5%	

Business Services Revenue Opportunity

(Dollars in billions)	2004	2005	2006	2007	2008	2009	2010	2006-10 CAGR
Voice	$ 55.3	$ 52.3	$ 50.5	$ 49.0	$ 47.4	$ 46.2	$ 45.0	-3.0%
Data	34.3	36.2	38.4	40.8	43.4	46.0	48.9	6.2%
Data Centers/Hosting	12.0	13.5	14.9	16.7	18.8	21.3	24.3	12.4%
Total Business	$ 101.6	$ 102.1	$ 103.7	$ 106.5	$ 109.7	$ 113.5	$ 118.2	3.0%

Business Services Annual Change

	2005	2006	2007	2008	2009	2010
Voice	-5.5%	-3.5%	-3.0%	-3.2%	-2.7%	-2.6%
Data	5.7%	5.8%	6.3%	6.4%	6.0%	6.4%
Data Centers/Hosting	13.2%	10.2%	12.2%	12.7%	13.3%	13.9%
Total Business	0.5%	1.6%	2.7%	3.0%	3.5%	4.1%

Business Services Revenue Components

	2004	2005	2006	2007	2008	2009	2010
Voice	54.5%	51.2%	48.7%	46.0%	43.2%	40.7%	38.0%
Data	33.8%	35.5%	37.0%	38.3%	39.6%	40.5%	41.4%
Data Centers/Hosting	11.8%	13.2%	14.4%	15.7%	17.2%	18.8%	20.6%

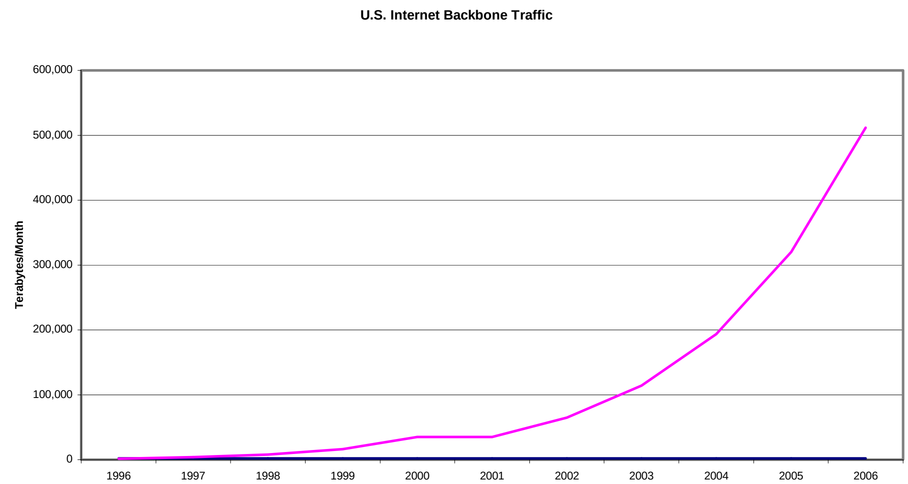
Source: Lehman Brothers and Gartner Group estimates

Demand Remains Robust

Traffic on the Internet doubled every year during the early part of this decade, and most network experts that we talked with suggest that traffic is still growing in the 40%–60% range annually.

While it may have been a myth that in 1999, "Internet traffic doubled every 100 days," we do not believe it would be an exaggeration to suggest that Internet traffic growth was, and remains, robust. Traffic on the Internet doubled every year during the early part of this decade, and as Figure 6 below illustrates, most network experts that we talked with suggest that traffic is still growing in the 40%–60% range annually. For example, Verizon recently confirmed with us that the combined VZ/MCI operations, now known as Verizon Business, saw IP traffic grow at an annual rate of 60% between December 2005–August 2006. In addition, AT&T recently announced that it has begun to upgrade its MPLS backbone to OC-768 speeds, quadrupling the backbone's current capacity—not a project likely undertaken to support a view of slowing data traffic growth.

Figure 6: Growth of U.S. Internet Backbone Traffic

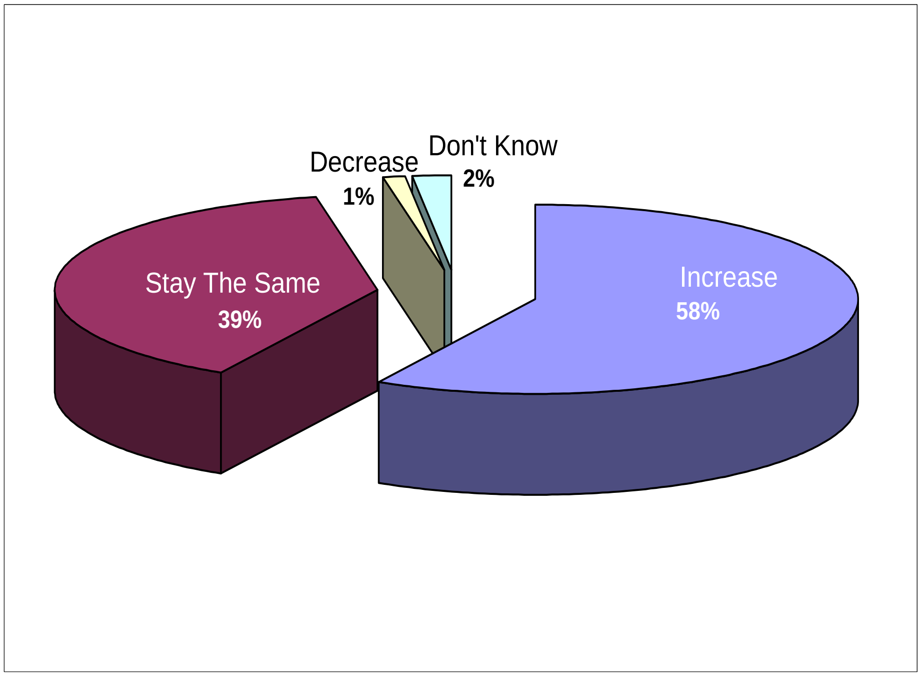


Source: A.M. Odlyzko, "Internet Traffic Growth: Sources & Implications," RHK and Lehman Brothers estimates

In our view, the level of IP traffic growth outlined above is translating into materially increasing data usage by corporations. IDC, in its annual U.S. WAN Manager Survey, interviewed 400 U.S. companies about their current wide area network (WAN) configuration and future plans for that network. We believe their findings support our view that the demand outlook in the Enterprise telecom services segment remains strong.

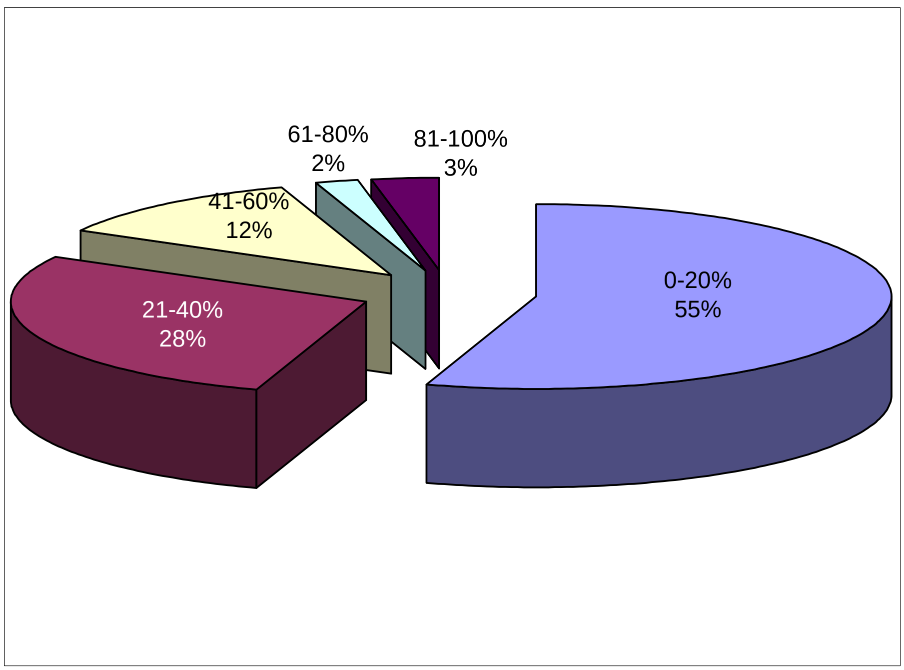
IDC's research suggests that 97% of the companies interviewed expect next year to use at least as much, or more, bandwidth as they are currently using. Of the companies expecting to use more bandwidth, 45% of the respondents expect their bandwidth requirements to grow in excess of 20%.

Figure 7: 12-Month Expectations on Bandwidth Usage



Source: IDC's U.S. WAN Managed Survey, 2006

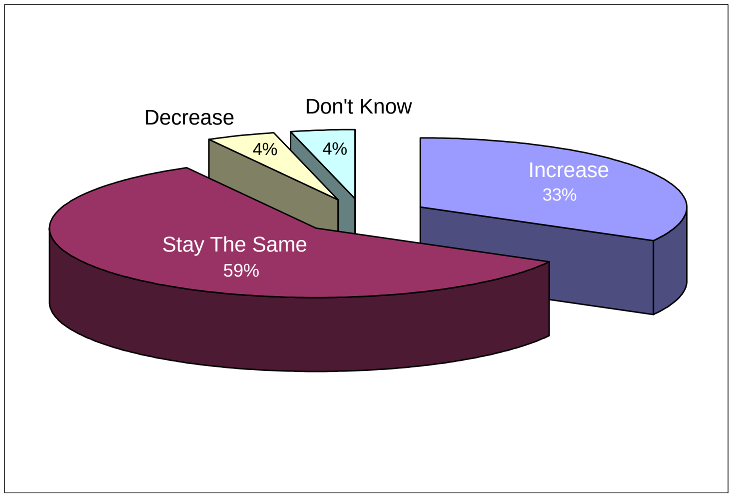
Figure 8: 12-Month Expectations on Bandwidth Growth



Source: IDC's U.S. WAN Managed Survey, 2006

More important to our analysis, the IDC research also suggests that, despite the buying power these companies have enjoyed in purchasing bandwidth over the past several years, over 90% of the enterprises surveyed have an expectation of either a flat or an increased level of spending to procure the increase in bandwidth.

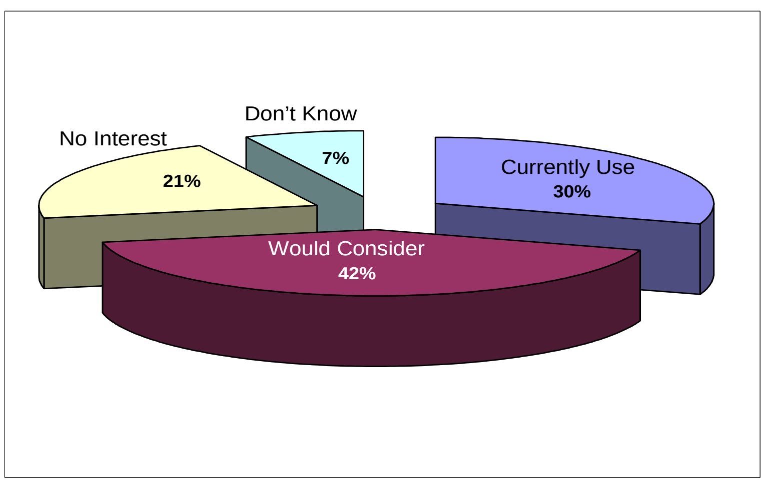
Figure 9: Enterprises 12-Month Change in Data Spending



Source: IDC's U.S. WAN Managed Survey, 2006

The movement of corporate applications to the network—everything from proprietary databases to HR functions—has created an opportunity, particularly for sophisticated providers of telecom services like the RBOCs and some emerging telco players. Given the critical nature of the voice and data network to nearly all enterprises' reliability, security and redundancy have grown in importance to most IT managers. The IDC survey data support our view that there is significant untapped interest and demand for higher-revenue and higher-margin add-ons to the existing data business. Nearly one-third of customers surveyed indicated that they are already paying their telco provider incremental fees to ensure network reliability. Another 40% of the respondents said they are currently considering paying for service-level agreements and class-of-service arrangements.

Figure 10: Enterprise Interest in Service-Level Agreements and Class-of-Service Arrangements



Source: IDC's U.S. WAN Managed Survey, 2006

Future Demand Drivers

During the past several years, there have been a series of innovations and applications that have driven the rapid growth in data and Internet usage. As noted above, data and Internet traffic is growing in the 40%–60% range and there is little reason to expect a change in trajectory. We believe there are several nascent trends that will spur additional demand during the next five years, among them:

- Wireless backhaul related to the growth in wireless data
- Web-based video
- Video calling
- Long-distance or "grid" computing
- Next-generation corporate data needs

We discuss a few of these below.

Wireless Data Expected to Dramatically Increase Backhaul Needs

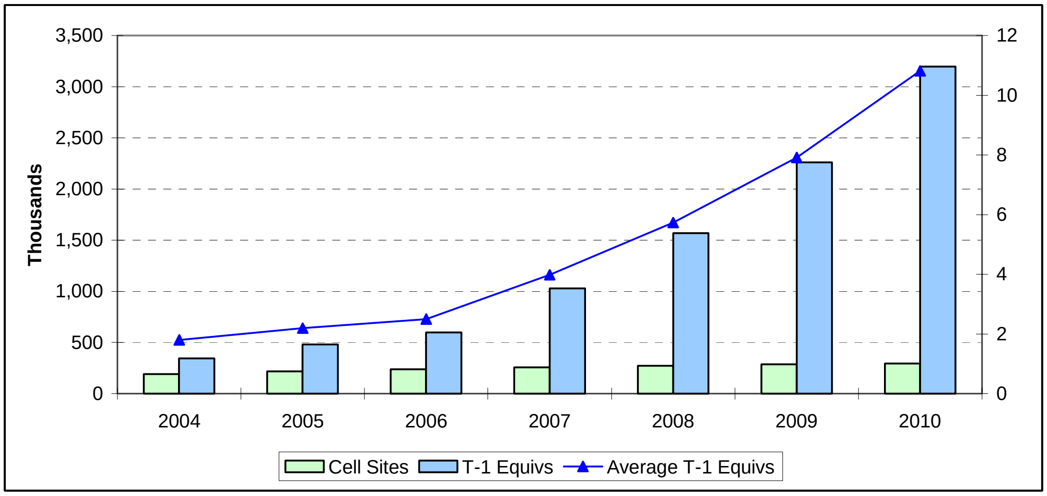
Wireless networks are fundamentally an access technology. The quicker that wireless carriers get the traffic into the ground, onto wired networks, the lower their cost is to carry voice and data traffic. Currently, the vast majority of cell sites are served by T-1s that transport what was a wireless call on the terrestrial network. In our opinion, the growth of 3G and 4G wireless data networks are dramatically increasing the backhaul needs of each cell site.

We believe wireless backhaul will be a significant addition to the demand for fiber-based data transport during the next several years. We estimate there will be approximately 240,000 towers sites at the end of 2006, with that number expected to reach nearly 300,000 by 2010. Our checks also lead us to believe there are approximately 600,000 T-1s serving these sites and fiber reaches fewer than 10% of them.

Our outlook for tower demand and usage suggests that wireline networks will dramatically increase the number of T-1 equivalents and the amount of fiber serving cell sites during the next five years.

Our outlook for tower demand and usage suggests that wireline networks will dramatically increase the number of T-1 equivalents and the amount of fiber serving cell sites during the next five years. In the past, as voice traffic and subscribers increased, wireless operators merely added cell sites and interconnected them with a couple of T-1s. We estimate there are about 2.5 T-1 equivalents reaching each cell site, or approximately 600,000 T-1s performing wireless backhaul. In the past, because traffic was predominantly voice, backhaul requirements per cell site were relatively stable. However, as 3G / 4G networks and broadband data applications proliferate, we believe cell sites will need terrestrial bandwidth to accommodate the increased traffic. As a result, a tower's revenue potential should begin to resemble office buildings with multiple high-usage tenants. GeoResults estimates that the combined voice and data traffic from tower sites could increase to 5x current levels within the next five years. As a result, we expect the number of T-1 equivalents could increase to slightly over 10 per cell site, and the total number of wireless backhaul T-1s could reach nearly 3.2 million.

Figure 11: Projected Growth in Cell Sites and T-1 Equivalent Backhaul Demand



Source: GeoResults and Lehman Brothers estimates

Video Trends Are Creating Additional Demand for Both Bandwidth and Hosting

During the past 12 months, video has emerged as a potentially significant new revenue stream for Enterprise telecom service providers. Below, we discuss two types of video and their general impact.

Web-Based Video

During the past 12 months, video has emerged as a potentially significant new revenue stream for Enterprise telecom service providers.

Industry observers estimate that YouTube, purchased last week by Google, is streaming 40 million videos and 200 terabytes of data per day. Companies like YouTube use a peer-to-peer architecture to deliver user-generated video content and copyrighted material directly to end users. Furthermore, companies such as Disney, Apple, and the television networks have begun making television shows and movies more widely available via the Internet. Finally, cable companies such as Comcast have expanded their video on demand offerings. While delivering this content creates demand for bandwidth providers, the opportunity is somewhat limited due to the peer-to-peer architecture. These video players will likely cache the content locally, which will reduce the amount of traffic that leaves the Internet and travels along a long-haul network. That said, we believe the network management opportunity these video services create could be significant.

Video Calling

Corporate and residential video calling could have a significant impact on backbone traffic for several reasons.

We believe video calling could experience material growth by 2010. Factors including the growth in corporate hubs in developing nations and periodic air travel concerns could finally spur the growth of this technology. Corporate and residential video calling could have a significant impact on backbone traffic for several reasons: Unlike peer-to-peer files, video calling cannot be cached locally; it requires transport bandwidth. In addition, TeleGeography estimates that if 10% of international calls were transmitted as video instead of voice, bandwidth requirements would rise 50% above the level required for voice calls alone.

Enterprise Grid Computing Is Small, But Could Grow Rapidly

Sources such as TeleGeography indicate that Enterprise network managers are increasingly interested in grid computing to efficiently utilize computing resources and process large amounts of data. Universities and research institutions were early adopters of Grid computing, which allows individual computers to share power and data storage. TeleGeography believes that grid computing could fuel dramatic growth in office-to-office bandwidth, noting that the U.S. National Science Foundation's research network, TereGrid, employs four 10 Gbps connections between each site.

The Pricing Environment Has Materially Improved

Consolidation Has Led to More Rational Competition

Consolidation among Enterprise service providers has emerged as one of the dominant trends of the last several years.

Consolidation among Enterprise service providers has emerged as one of the dominant trends of the last several years. In 2006 alone, there have been 16 significant transactions worth more than $4 billion. Level 3 alone has been responsible for over one-quarter of the transactions in the last two years. All of this M&A activity has both concentrated excess capacity and reduced the potential for an irrational competitive environment. We believe a much more stable pricing environment has resulted, and in our view, this trend will likely continue.

In order to effectively compete against AT&T / SBC and VZ / MCI, all competitive service providers are looking for ways to reduce the cost to bring traffic onto their networks and deliver it to the ultimate destination. In other words, they must find ways to reduce last-mile costs. We believe this goal motivated several of the recent transactions, including Time Warner Telecom / Xspedius, Level 3 / Looking Glass, Qwest / OnFiber, Level 3 / TelCove, and Level 3 / ICG. By eliminating the payment of access and migrating traffic onto their own networks, we estimate that incremental margins improve to greater than 80%, versus the 40%–50% when originating and terminating traffic over another carrier's facilities.

CLECs are also merging in order to increase the density of their networks, to improve the utilization of deployed switches. Greater switch efficiency and improved network density are particularly important for traffic that terminates on ILEC facilities. We believe this goal motivates the PAETEC / US LEC, Eschelon / Mountain Tel / Oregon Tel / ATC, Choice One / Conversant / CTC, Integra Telecom / Electric Lightwave, and XO / Allegiance mergers.

These mergers enable the combined carriers to rely on fewer switches and better utilize their interoffice transport and long-haul facilities.

We believe fiber-to-building Points of Presence are somewhat analogous to Tower assets in the wireless space.

We believe fiber-to-building Points of Presence are somewhat analogous to Tower assets in the wireless space. As with a tower company, an adequate return on capital can be achieved by obtaining a single customer within an office building that has been wired with fiber. Material upside on revenue and margins can be realized by additional customers from that same building. In our view, these scarce assets could attract significant interest from backbone and non-RBOC affiliated wireless players.

Figure 12: Recent Transactions Involving CLECs and Backbone Providers

Date Announced	Acquiror	Target	Transaction Value (in millions)
17-Oct-06	Level 3 Communications	Broadwing	$ 1,193
Aug-06	PAETEC Communications	USLEC Corporation	543
Jul-06	Time Warner Telecom	Xspedius	532
Jun-06	Eschelon Telecom	Mountain Telecom	40
Jun-06	Broadview Network Holdings	ATX Communications	91
Jun-06	Level 3 Communications	Looking Glass Networks	165
May-06	Qwest Communications	OnFIber Communcations	107
May-06	Telepacific	Mpower	193
May-06	Level 3 Communications	TelCove	1,238
Apr-06	Level 3 Communications	ICG Communications	163
Mar-06	Choice One Comms/CTC	Conversant	na
Feb-06	Choice One Comms	CTC Communications	na
Feb-06	Integra Telecom	Electric Lightwave	247
Jan-06	Elantic	Cavalier Telephone	na
Jan-06	Eschelon Telecom	Oregon Telecom	20
Jan-06	Level 3 Communications	Progress Telecom	146
Nov-05	Elk Associates	XO Communications	700
Oct-05	Level 3 Communications	WilTel	725
Oct-05	Talk America	Network Telephone	20
Mar-05	Level 3 Communications	360 Networks (network assets)	na
Oct-04	Eschelon Telecom	Advanced TelCom	45
Jul-04	M/C Venture Prtnrs/Columbia Cap	ICG Communications	102
Mar-04	Corvis Corp	Focal Communications	210
Feb-04	XO Communications	Allegiance Telecom	646
			$ 7,126

Level 3 alone has made 7 significant acquisitions.

Source: Lehman Brothers and company reports

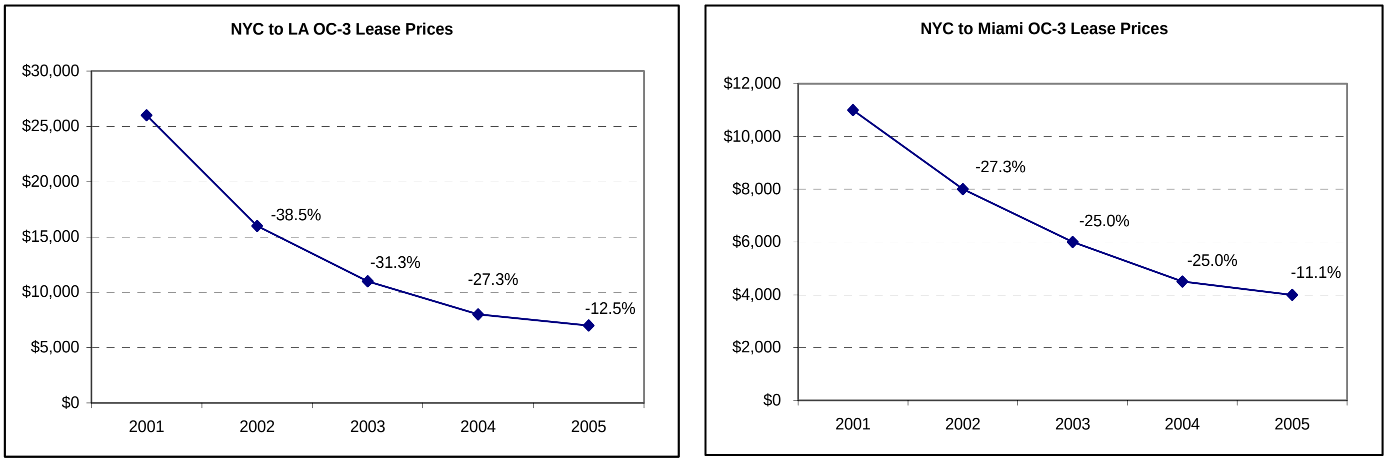
Transport Prices Have Begun to Firm

We believe the aforementioned consolidation has led to a much more rational pricing environment, particularly for transport services.

We believe the aforementioned consolidation has led to a much more rational pricing environment, particularly for transport services. From 2000–2004, we estimate bandwidth pricing declined 30%–50% per year; while volume growth offset some of the decline, bandwidth revenue for the long-haul business fell. The AT&T / SBC and VZ / MCI mergers, as well as Level 3's recent acquisitions, have reduced the number of companies competing, at scale, nationally for long-haul transport and high-bandwidth Internet access to approximately seven (Level 3, Global Crossing, Broadwing, Qwest, Sprint, AT&T, and Verizon). A Level 3 / Broadwing merger would reduce that number to six.

While rate decreases still persist, we believe the gap between embedded average prices in carriers' customer bases and the current renewal point-of-sale price has significantly narrowed during the past 12–24 months. Since the beginning of 2005, the rate of decline for bandwidth pricing has slowed to the 10%–20% range. This dynamic is illustrated in Figure 13, on two widely used telecom routes. Additionally, carriers are attempting to migrate from raw bandwidth offerings to higher value-added services, such as managed bandwidth and other network services. This strategy has allowed carriers to differentiate their offerings and, in some isolated instances, to raise prices.

Figure 13: Price of OC-3 Leases on Two Major Domestic Routes



Source: TeleGeography and Lehman Brothers estimates

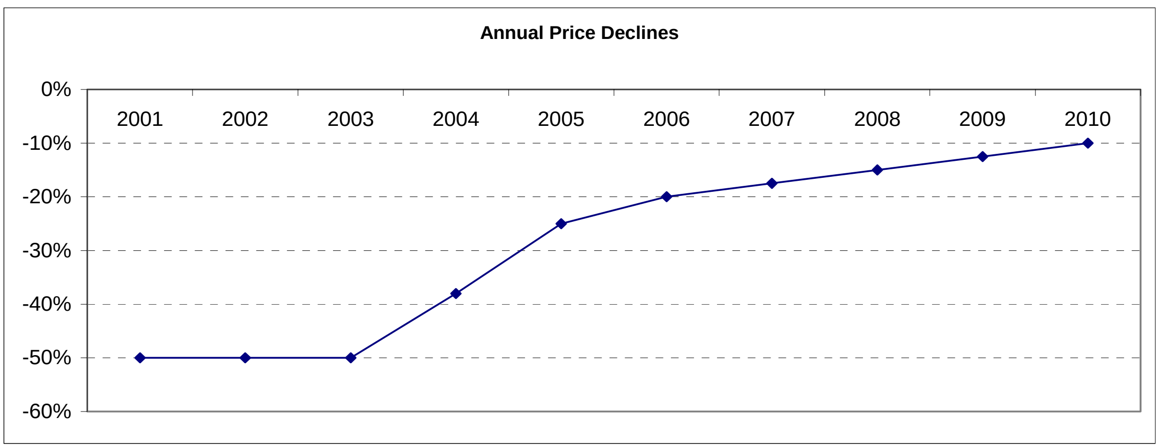
Pricing Model Suggests Return to Growth in 2007 or Early 2008

To analyze the dynamic of the gap closing between the embedded average price in a carrier's customer base and the current renewal point-of-sale price, we constructed a simple model. In Figure 14 below, we present a hypothetical analysis of the impact of stabilizing prices and contract rate renegotiation on carrier revenues from 2000–2010. We modeled five-year contracts, roughly 40% annual traffic growth, and assumed 50% price declines in 2001–03 (years in which numerous transport carriers lit networks), a 38% decline in 2004, and then declines moderating to 15% by 2008—a real world approximation. As illustrated in our model, as customers rotated onto new contracts, the lower rates caused declines in revenue in 2005 and 2006. The model suggests relatively stable revenue in 2007, and a return to growth in 2008–10. Interestingly, this trajectory is roughly the path that investors have been informed to expect by the AT&T and Verizon Business management teams. Consequently, we are comfortable that this phenomenon is not just wishful thinking. We expect that as embedded price points roll off on Enterprise telecom contracts signed three to five years ago, and traffic volumes continue to expand, in late 2007 or early 2008, the Enterprise businesses of AT&T and Verizon should return to top-line expansion.

Figure 14: Impact of Contract Renewals on Telecom Services Pricing

2008 is the point of revenue inflection.

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Traffic Growth	*1,000*	1,400	1,960	2,744	3,842	5,378	7,530	10,541	14,758	20,661	28,925
		40%	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*	*40%*
Price											
2000	*$1.00*	$1.00	$1.00	$1.00	$1.00						
2001		$0.50	$0.50	$0.50	$0.50	$0.50					
2002			$0.25	$0.25	$0.25	$0.25	$0.25				
2003				$0.13	$0.13	$0.13	$0.13	$0.13			
2004					$0.08	$0.08	$0.08	$0.08	$0.08		
2005						$0.06	$0.06	$0.06	$0.06	$0.06	
2006							$0.05	$0.05	$0.05	$0.05	$0.05
2007								$0.04	$0.04	$0.04	$0.04
2008									$0.03	$0.03	$0.03
2009										$0.03	$0.03
2010											$0.03
Annual Price Decline		*-50.0%*	*-50.0%*	*-50.0%*	*-38.0%*	*-25.0%*	*-20.0%*	*-17.5%*	*-15.0%*	*-12.5%*	*-10.0%*
Revenue	$1,000	$1,050	$1,132	$1,286	$1,500	$1,087	$839	$728	$747	$843	$993
Change		5.0%	7.8%	13.6%	16.6%	-27.5%	-22.8%	-13.2%	2.6%	12.9%	17.7%
Average rate	$ 1.00	$ 0.75	$ 0.58	$ 0.47	$ 0.39	$ 0.20	$ 0.11	$ 0.07	$ 0.05	$ 0.04	$ 0.03
Change		-25%	-23%	-19%	-17%	-48%	-45%	-38%	-27%	-19%	-16%



Source: Lehman Brothers estimates

We Believe the RBOCs Are Well-Positioned to Exploit Trends in Business Services

We estimate that aggregate data revenue currently represents slightly above 50% of Business Services telecom spending, approximately $53 billion annually. The revenue potential varies significantly for various product categories in Enterprise data services. Some of the more mature services, such as Frame Relay and ATM, are shrinking; however, newer services like IP/VPNs, Metro Ethernet, and Hosting are growing rapidly. In Figure 15 below, we estimate the opportunity and growth outlook for several distinct segments of Data and Data Centers/Hosting/Content Delivery. We discuss several of these categories in detail below. We would note at the outset, however, that the RBOCs, despite sizable legacy Enterprise data businesses, are the market share leaders in virtually every rapidly growing data category. Consequently, we believe they are among the best-positioned carriers to exploit the robust demand environment for advanced data services and applications.

Figure 15: 2004 – 10 Data Services Demand Forecast

Data Services								
(Dollars in millions)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2006-10 CAGR**
Unmanaged Business Data								
Transport	$11,000	$10,611	$10,138	$ 9,701	$ 9,340	$ 9,074	$ 8,945	-3.4%
Legacy Packet	9,500	8,536	7,662	6,831	5,987	5,135	4,266	-13.0%
IP (Direct Internet Access)	5,800	7,365	8,967	10,534	12,193	13,688	15,145	15.5%
Fiber/Ethernet	550	798	1,049	1,444	1,919	2,443	3,017	30.5%
Other High Speed	2,200	2,545	2,847	3,180	3,486	3,745	3,992	9.4%
Total Unmanaged Business	29,050	29,855	30,663	31,690	32,925	34,086	35,365	3.4%
Managed Data Networks	5,250	6,394	7,697	9,105	10,471	11,922	13,568	16.2%
Data Centers/Hosting/Content Delivery	11,950	13,525	14,902	16,714	18,845	21,350	24,313	12.4%
Total Business Data	$46,250	$49,775	$53,262	$57,509	$62,242	$67,357	$73,246	8.0%
Market Share (without Wholesale)								
Verizon		15.0%	14.5%	13.9%	13.8%	13.7%	13.7%	
AT&T/BellSouth		25.0%	24.5%	24.0%	23.9%	23.9%	23.9%	
Qwest		5.0%	4.9%	4.9%	4.8%	4.7%	4.5%	
Sprint		4.8%	4.4%	4.1%	3.8%	3.5%	3.3%	

Source: Lehman Brothers and Gartner Group estimates

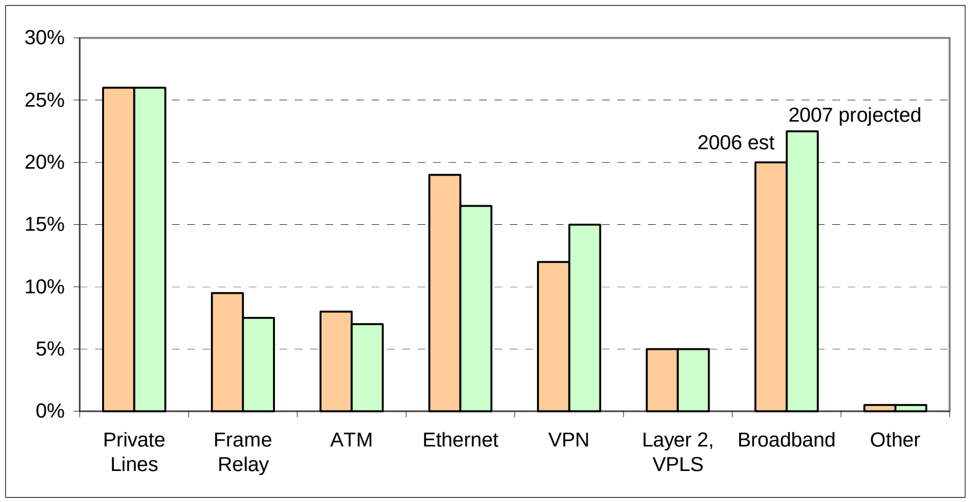
Mid-Single-Digit Growth for General Unmanaged Data Services

The market for Data Services is going through a transition, as large enterprises consolidate leased lines into fewer, larger, and more efficient DS-3 and OC-N circuits. As a result, we anticipate the $11 billion leased line data services business will decrease approximately 3% annually, as the increased reliance on OC and DS-3 circuits is offset by attrition of DS-0 and T1 circuits. Although the RBOCs have significant share of the shrinking transport data business, our research shows that they are also well-positioned for growth in a fast-growing substitutive category, Direct Internet Access—which is growing at 16% annually.

For smaller enterprises, we believe much of the analog data and T1 revenue streams will also migrate to more cost-effective DSL, Ethernet, and IP offerings, which we expect will grow approximately 10% annually for the next three to five years. For emerging carriers, the predominant data trends provide healthy growth prospects. However, we also foresee the RBOCs successfully managing the shift in traffic mix to more network-efficient technologies in order to control the revenue erosion for their imbedded data services. Consequently, we believe the RBOCs will grow, or at least maintain, market share in this expanding revenue opportunity.

With respect to legacy packet services such as Frame Relay and ATM, we expect continued erosion—our forecast calls for a 13% annual decline through 2010. However, there is evidence that these legacy packet services may have a much longer life, given that the majority of the remaining customers on these platforms—governments and financial institutions—tend to like their reliability and are less inclined to do a complicated migration to IP-based services. As illustrated in Figure 16, IDC's previously cited WAN Manager Survey suggests that the migration off of Frame Relay and ATM ports may be slower than many expect. We believe this has positive revenue implications for AT&T and Verizon, which have larger legacy data revenue bases.

Figure 16: Composition of WAN Ports



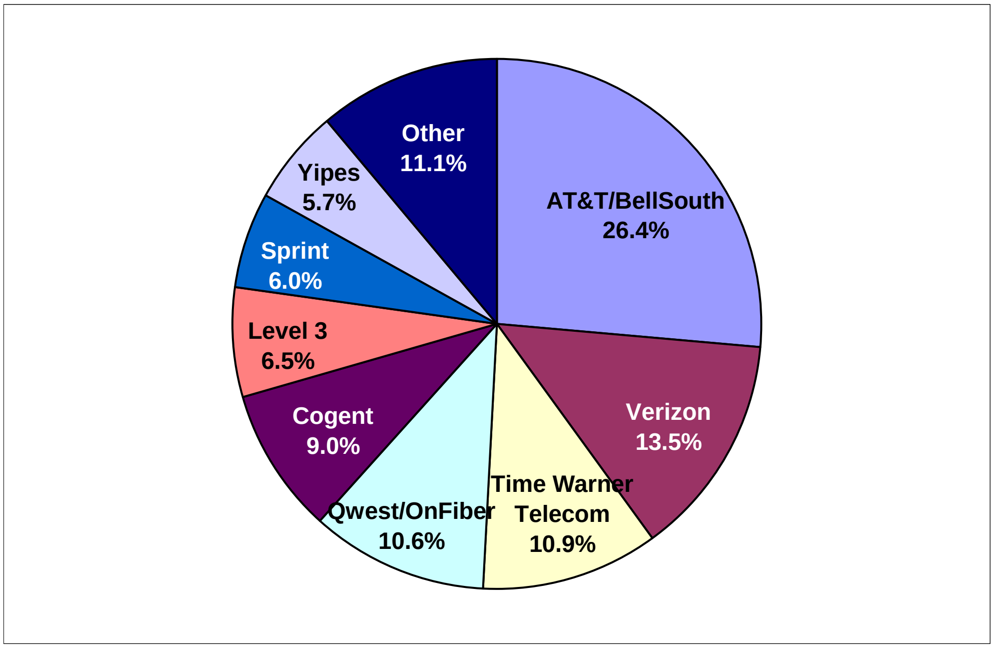
Source: IDC's US WAN Managed Survey, 2006

Higher-Margin Managed Services – the Fastest-Growing Product Set

We expect mid-teens growth for managed services, as the RBOCs become somewhat more aggressive in promoting them while holding the line on prices for both their new and legacy businesses.

In addition to facilitating the leased line migration, we believe all service providers are seeking to increase managed service revenue primarily via IP virtual private networks (VPNs) with increasing use of Ethernet services. Integrated access to voice and data networks and real-time long-distance Enterprise applications are hastening managed service trends. Meanwhile, the RBOCs are also serving and harvesting the legacy ATM and frame relay networks, which compete for resources and are in a slow decline. Overall, we estimate managed services have recently grown approximately 20% as users migrate away from unmanaged T1, frame relay, and ATM, to managed IP VPN and Ethernet applications. We believe emerging carrier Time Warner Telecom has been particularly effective in spreading Ethernet and using it to build a managed services revenue stream. In fact, according to Vertical Systems Group, TWTC is the No. 3 provider behind AT&T and Verizon, with 10.9% of the market (see Figure 17 below). We expect mid-teens growth for managed services, as the RBOCs become somewhat more aggressive in promoting them while holding the line on prices for both their new and legacy businesses.

Figure 17: Mid-2006 Retail Ethernet Share



The RBOCs, Cogent and Time Warner Telecom provide 70% of the Ethernet ports.

Source: Vertical Systems Group – ENS

Over the next several years, we believe Enterprises will start to embrace the telecom service providers' ability to manage their networks in a more cost-effective manner.

In our opinion, service providers, including the RBOCs, are promoting better quality of service (QoS), service-level agreements (SLAs), and mission-critical real-time applications. In the past, the large Enterprise customers have predominantly chosen to manage their own voice and data networks; as a result, the RBOCs have struggled to offer higher-margin service. However, over the next several years, we believe Enterprises will start to embrace the telecom service providers' ability to manage their networks in a more cost-effective manner. We believe the IDC report mentioned above supports our view. Furthermore, Enterprise carriers are beginning to realize that internally managed voice and data networks do not create a competitive advantage, which should lead to a greater reliance on outsourcing.

Pricing Power Exists in Data Centers/Hosting

We estimate the market for Data Centers/Hosting/Content Delivery is $15 billion and will grow in the low to mid-teens for the next several years, generating nearly $25 billion in revenue by 2010. Business IP services are offered by the RBOCs and independent Web hosting companies such as Cogent, Savvis, and Equinix. These companies and others offer Internet access, rack space for customer equipment (a.k.a. co-location services), and higher-margin consulting services. The RBOCs have focused on network access and co-location services, while companies such as Savvis provide a more robust suite of consulting services.

In our opinion, small businesses, formerly using their own facilities to establish an online presence, are migrating in greater numbers to shared Web hosting. New shared Web hosting customers will typically buy basic packages bundled with domain registration and similar services. These customers have learned that managing the operation of a Web site does not create a competitive advantage.

Co-location is also experiencing a renaissance, primarily due to increasing prices, somewhat scarcer supply, increased demand for space for business continuity, and the use of co-location as a replacement or supplement for an internal data center. Recent natural disasters pushed a large number of businesses to consider off-site backup and geographic diversity. In fact, Gartner reported that there are co-location constraints in San Francisco; Washington, DC; New York City; Chicago, and Los Angeles. According to Gartner, providers have begun pushing up prices 30%–70% and, in the short term, we do not expect supply to catch up with demand. Space constraints and increased demand for managed services have also caused hosting companies to aggressively move co-located customers to more expensive offerings. In some instances, mere co-location contracts are not renewed or expanded, and customers have been forced to move to different facilities.

We believe growth in streaming media, as well as the stabilization of bandwidth prices, will drive the growth of basic content delivery solutions.

We believe growth in streaming media, as well as the stabilization of bandwidth prices, will drive the growth of basic content delivery solutions. The online delivery of applications and other networking services is also rapidly growing. "Software as a service" will drive growth of complex Web hosting as numerous software companies seek infrastructure partners. In our opinion, streaming media will stimulate growth of content delivery networks for the next several years.

There are numerous vendors vying for the data center / hosting revenue and it remains a relatively fragmented market. According to IDC, IBM, the Web hosting leader, had nearly 18% market share in 2005. However, AT&T / SBC, Verizon / MCI, and Qwest took share last year. In our opinion, these and other network-centric providers will be increasingly successful at consolidating this business by offering a combination of data centers with robust Internet access, hosting services (e.g., security and storage), virtualization (in the case of Savvis), and traditional wide area networks as the platform for managed services or applications.

Figure 18: Hosting Revenue and Market Share (excludes Access and Content Delivery Services)

	Revenue			Growth		
	2003	2004	2005	2004 vs 2003	2005 vs 2004	2005 Market Share
IBM	$ 1,368.3	$ 1,586.3	$ 1,216.7	15.9%	-23.3%	17.6%
EDS	336.0	361.8	434.2	7.7%	20.0%	6.3%
AT&T/SBC	321.5	359.5	424.2	11.8%	18.0%	6.1%
SAVVIS	34.3	261.5	294.6	662.4%	12.7%	4.3%
Verizon Business/MCI	166.6	167.8	210.4	0.7%	25.4%	3.0%
Verio	162.1	166.1	167.8	2.5%	1.0%	2.4%
Rackspace	58.6	90.8	139.0	54.9%	53.1%	2.0%
Equinix	110.5	154.4	136.7	39.7%	-11.5%	2.0%
Yahoo! Small Business			135.0			1.9%
Qwest	90.0	94.9	113.9	5.4%	20.0%	1.6%
Sungard/Inflow	48.0	66.0	105.0	37.5%	59.1%	1.5%
CSC	85.1	111.2	88.1	30.7%	-20.8%	1.3%
NaviSite	73.4	77.3	87.9	5.3%	13.7%	1.3%
Web.com/Interland	102.7	91.7	83.9	-10.7%	-8.5%	1.2%
VeriCenter	9.9	38.3	50.3	286.9%	31.3%	0.7%
XO	48.9	44.1	44.5	-9.8%	1.0%	0.6%
Data Return	27.7	30.2	41.8	9.0%	38.4%	0.6%
EarthLink	48.0	48.0	40.7	0.0%	-15.2%	0.6%
Globix	54.1	55.5	33.6	2.6%	-39.5%	0.5%
Go Daddy!			30.6			0.4%
AboveNet	57.8	48.9		-15.4%	-100.0%	0.0%
Cable & Wireless	406.8					0.0%
Other	1,897.7	2,186.6	3,049.6	15.2%	39.5%	44.0%
	$ 5,508.0	$ 6,040.9	$ 6,928.4	9.7%	14.7%	100.0%

The RBOCs gained share in 2005.

Source: IDC

Voice Remains in Decline

The $50 billion Business Voice market is in steady decline due to persistent access line loss. We believe the impact of fewer lines has been somewhat mitigated by reduced carrier competition, which has stabilized price declines during the past two years. As a result, we forecast low single-digit declines in Voice business revenue for the next few years. By 2010, Business Voice services could become a $45 billion market, representing less than 40% of business spending on telecom services.

AT&T and Verizon Business Services Revenue Should Begin Growing in 2008

The AT&T/SBC and VZ/MCI mergers have created two dominant Business Services carriers serving approximately 40% of the market.

In 2006, we forecast the RBOCs and Sprint will have combined Business Services revenue of approximately $60 billion, which represents just over three-fifths of the Business Services market. The AT&T/SBC and VZ/MCI mergers have created two dominant Business Services carriers serving approximately 40% of the market. (When the proposed BellSouth merger closes, AT&T and Verizon will control more than one-half of the Business Services market.) For all the reasons mentioned in this report, we believe trends in this segment of the market will likely produce across-the-board growth in RBOC revenue by 2008. After low single-digit declines in Business Services revenue in 2006 and flattish performance in

2007, we expect both AT&T and Verizon to show low single-digit growth in 2008, with the potential for greater growth in 2009 and 2010.

Although in the low single digits, we believe the change in revenue trajectory will likely lift EBITDA and EPS given the fixed-cost nature of telecom services. For a more detailed discussion on the potential impact of this change, please see our two related notes, "Verizon Communications: Engineering Growth for the Long Term" (October 18, 2006), and "AT&T: USS AT&T Has Turned, Open Seas Ahead" (October 18, 2006).

Figure 19: RBOC Business Services Revenue Trends

Dollars in billions	2005	2006E	2007E	2008E	2009E	2010E
Verizon	$ 19.9	$ 19.7	$ 19.8	$ 20.2	$ 20.7	$ 21.4
AT&T/BellSouth	32.1	31.6	31.8	32.6	33.7	35.2
Qwest	5.1	5.3	5.5	5.7	5.9	6.0
Sprint	4.8	4.6	4.6	4.5	4.5	4.4
Others	40.3	42.4	44.8	46.6	48.8	51.2
	$ 102.1	$ 103.7	$ 106.5	$ 109.7	$ 113.5	$ 118.2

	Annual Change					
	2005	2006E	2007E	2008E	2009E	2010E
Verizon		-0.9%	0.5%	2.2%	2.7%	3.3%
AT&T/BellSouth		-1.3%	0.5%	2.5%	3.4%	4.5%
Qwest		3.5%	4.2%	3.3%	2.3%	2.1%
Sprint		-2.4%	-1.6%	-1.4%	-1.1%	-0.9%
Others		5.4%	5.5%	4.1%	4.6%	4.9%
Total		**1.6%**	**2.7%**	**3.0%**	**3.5%**	**4.1%**

Source: Company documents and Lehman Brothers estimates

Summary of Company Ratings Changes and Price Target Adjustments

Established AT&T 2007 Price Target of $42

Our new year-end 2007 price target of $42 is equal to 14.0x our 2008 EPS estimate of $3.00, which includes the impact of AT&T's potential acquisition of BellSouth.

Based on our improved outlook for revenue trends in the Business/Enterprise services segment, we established a year-end 2007 price target for AT&T of $42, up from our prior year-end 2006 price target of $30. Our new 2007 price target is equal to 14.0x our 2008 EPS estimate of $3.00, which includes the impact of AT&T's potential acquisition of BellSouth. **Lehman Brothers is acting as financial advisor to AT&T on the potential acquisition of BellSouth.** Our targeted multiple represents approximately 90% of the current S&P 500 consensus forward-year earnings multiple of 15.4x. This is at the higher end of the RBOCs' historical relative trading multiple of 80%–90%, which we believe is warranted due to our outlook for strong EPS growth at T. Our price target implies a 31% potential total return by year-end 2007. Our old 2006 price target was equal to 13.0x our old 2007 EPS estimate of $2.55, which also included the impact of AT&T's potential acquisition of BellSouth.

Established BellSouth 2007 Price Target of $55.65

We established a 2007 price target for BellSouth (BLS) of $55.65. Our price target for BLS is based on the terms of the potential T/BLS merger, in which BLS shareholders are to receive 1.325 shares of T for each share of BLS. Our old price target for BLS of $43.73 was also based on the merger exchange ratio and our prior price target for T of $30. See above for our old and new valuation methodology for T.

Upgraded Verizon to 1-Overweight and Established 2007 Price Target of $41

Our new year-end 2007 price target of $41 is equal to 14.3x our 2008 EPS estimate of $2.87.

Based on our improved outlook for revenue trends in the Business/Enterprise services segment, we upgraded Verizon to 1-Overweight and established a year-end 2007 price target of $41, up from our prior year-end 2006 price target of $37. Our new 2007 price target is equal to 14.3x our 2008 EPS estimate of $2.87. Our targeted multiple represents approximately 90% of the current S&P 500 consensus forward-year earnings multiple of 15.4x. This is at the higher end of the RBOCs' historical relative trading multiple of 80%–90%, which we believe is warranted due to our outlook for strong EPS growth at VZ. Our price target implies 15% potential total return by year-end 2007. Our old year-end 2006 price target was equal to 13.0x our old 2007 EPS estimate of $2.73. Our targeted multiple represented approximately 90% of the then current S&P 500 consensus forward-year earnings multiple of 14.5x. This was at the higher end of the RBOCs' historical relative trading multiple of 80%–90%.

Established Qwest 2007 Price Target of $8

We have not adjusted our estimates for Qwest Communications International (Q, rated 2-Equal weight). Rather, we established a year-end 2007 price target of $8, up from our prior year-end 2006 price target of $7. The increase assumes a 2007E EV/EBITDA multiple of ~6.0x and a 2007E FCF yield of ~10.5% (which equates to a buyback "payout" of ~6.5%). Our prior year-end 2006 target of $7.00 was based on 5.75x 2006 wireline EBITDA of $4.4 billion, 1.5x 2006 wireless revenue of $560 million, net debt of $13.2 billion, and shares outstanding of 1.9 billion. Q is currently trading at 6.1x 2007E EBITDA. This is at the high end of the range for its RBOC peers, which are trading at 5.0x–6.0x, and above Sprint Nextel, which is trading at 5.1x. However, Q is currently trading at a 10.3% 2007E FCF yield, compared with yields of 5%–7% for its large-cap Telecom Services peers. While this does seem more attractive, we note that the sources of Q's FCF are more comparable to the RLECs than to the RBOCs (which generate a great deal of FCF from wireless) or a pure-play wireless carrier such as Sprint.

Upgraded Cogent to 1-Overweight and Established 2007 Price Target of $17

We believe CCOI's asset portfolio is among the most attractive in the emerging telecom space.

In conjunction with this report highlighting the improving trends in Business Telecom Services, we upgraded CCOI to 1-Overweight and established a 2007 price target of $17. Please see our related note, "Cogent Communications Group: The Tower of Wireline Telecom" (October 18, 2006). In our view, industry demand should continue to support healthy growth multiples. Additionally, we believe consolidation trends favor facilities-based players with strong growth outlooks such as CCOI. Cogent is currently trading at approximately 15x our EBITDA forecast, versus Level 3 and Broadwing (which Level 3 is expected to acquire in 1Q07), which are trading at approximately 13x and 20x IBES consensus, respectively. At our 2007 price target of $17, Cogent would trade at 19x our 2007 EBITDA forecast, which we believe is warranted given its potential for faster revenue and EBITDA growth than both Time Warner Telecom and Level 3 / Broadwing. Additionally, we believe CCOI's asset portfolio is among the most attractive in the Emerging Telecom space.

CCOI Price Target Methodology

Our 2007 price target of $17 for CCOI is based on a DCF analysis (WACC of 11.7% and terminal FCF growth of 3%) and Cogent's EV / 2007E EBITDA multiple vs. its peers. Our 2007 EBITDA estimate for Cogent is $45.4 million. Our DCF analysis yields a $16 per-share price target, which implies approximately 18x EV / 2007E EBITDA. Cogent currently trades at approximately 15x EV / 2007E EBITDA, versus Level 3 at approximately 13x, Broadwing at approximately 20x, and Time Warner Telecom at approximately 10x. At our $17 price target, Cogent would trade at approximately 19x EV / 2007E EBITDA. This multiple is reasonable, in our view, because we expect Cogent to grow both revenue and EBITDA significantly faster than Level 3, Broadwing, and Time Warner Telecom.

Established Time Warner Telecom 2007 Price Target of $27 and Expecting Strong 3Q06

In a consolidating industry, we favor companies with the most attractive asset portfolios; Time Warner Telecom is one of those companies.

In conjunction with this report highlighting the improving trends in Business Telecom Services, we established a 2007 price target of $27 on the shares of Time Warner Telecom. In a consolidating industry, we favor companies with the most attractive asset portfolios; Time Warner Telecom is one of those companies. In addition to strong industry fundamentals, our recent checks indicate that 3Q06 Enterprise sales momentum is sound and the company has a healthy sales pipeline into 4Q06. We expect the announced acquisition of Xspedius to close by the end of 2006, and we believe the combined footprint and customer base will likely improve TWTC's 2007 growth outlook and operating leverage. Finally, the September 2006 offering of all Time Warner and Advance Newhouse shares removed a potential overhang on the shares. TWTC shares currently trade at approximately 10x 2007E EBITDA vs. LVLT at approximately 13x, BWNG (which Level 3 is expected to acquire in 1Q07) at approximately 20x, and Cogent at approximately 15x. Our price target values TWTC shares at approximately 13x 2007E EBITDA.

We arrived at our 2007 price target for TWTC by giving equal weight to a discounted cash flow methodology (terminal growth rate of 3.5% and WACC of approximately 11%) and valuation versus the TWTC comps. Using a DCF methodology, we estimate TWTC's private market enterprise value is $5.7 billion. After subtracting net debt of approximately $548 million and applying a public market discount of 20%, we believe TWTC's public market equity value is approximately $4.1 billion, or approximately $24 per share, assuming approximately 168 million shares outstanding after the impact of its convertible senior debentures, options, and the proposed Xspedius acquisition. In our opinion, TWTC should trade at an EV/2007E EBITDA multiple comparable to its peers, or 14x. Its peers, Level 3, Cogent, and Broadwing, currently trade at 13x–20x, or $30 per share. Giving equal weight to the two methodologies yields our $27 price target. At our 2007 price target, TWTC would trade at approximately 13x our 2007 EBITDA estimate, which we believe is reasonable given its growth outlook and high-quality assets.

Eschelon Price Target Methodology

We believe an EV/2007E EBITDA multiple of approximately 6x for ESCH is reasonable, given that the company has demonstrated sustained success and should grow at the high end of its peer group range.

Our Eschelon price target of $20 is based on a combination DCF analysis (WACC of approximately 12.5% and terminal FCF growth of approximately 1.5%) and EV/2007E EBITDA multiple analysis vs. ESCH's peers. Our DCF analysis yields a private market Enterprise Value of approximately $531 million. After subtracting net debt of $100.3 million, we arrive at a private market Equity Value of approximately $431 million. Applying a public market discount of 20% implies an approximate $345 million public market equity value, or approximately $18 per fully diluted share. Our 2007 EBITDA estimate for ESCH is $77 million. ESCH currently trades at approximately 4.0x EV/2007E EBITDA, versus Time Warner Telecom at 8x, Cogent at 10x, Cbeyond (CBEY) at 13x, and US LEC (CLEC) at 7x. We expect ESCH to grow EBITDA 20%–25% annually from 2006–10 vs. 15%–17% for TWTC, 65%–70% for CCOI, and consensus expectations of 30% for CBEY and 40% for CLEC. We believe an EV/2007E EBITDA multiple of approximately 6x is reasonable given that ESCH has demonstrated sustained success and should grow at the high end of its peer group range. However, we would expect some discount versus TWTC and CCOI, given that ESCH lacks last-mile connectivity, which we believe gives it lower relative operating leverage. Placing equal emphasis on ESCH's projected EV/2007E EBITDA multiple and its DCF value yields a $20 price target for the stock.

Risks to Our Sector Upgrade

The Economy

Growth in the telecom sector, particularly Business Services, is tied to the economy. If company formations, or business growth should slow, the demand for both voice and data telecom services could decline. For example, the modest business growth experienced in 2002 led to the poor business telecom services demand environment during that period. A similar economic slowdown could also reduce telecom demand. In addition, higher interest rates could slow economic growth during the next two to three years, and the RBOCs' return to revenue growth in Business Services could be delayed.

Reoccurrence of Widespread Irrational Pricing

Our positive outlook for the Business Services market is also predicated on a continued rational pricing environment. As detailed above, transport rates along major routes in the United States declined 30%–40% in 2002. In 2005, the annual rate of decline had stabilized to approximately 15%. In our view, if aggressive price competition returns and annual price declines reach 2002 levels, Business Services revenue at AT&T and Verizon may not return to growth in the next two to three years, as we currently expect.

We Believe the Regulatory Climate Is Favorable and Election Results Should Not Appreciably Increase Downside Risk

Legislative

In our view, the legislative and regulatory environment of Telecom Business Services is generally favorable. Recently, the emphasis has been on regulatory changes that affect the Consumer market. Specifically, the RBOCs have sought a streamlined process for new video service providers to compete with traditional cable television providers. At this point, several states have passed legislation that enables new video entrants to acquire a statewide franchise to offer video services; as a result, interest in federal legislation has begun to wane, but remains on the agenda with diminished emphasis. Network neutrality is another legislative and regulatory buzzword. Although it has generated much debate, the issue has failed to coalesce into a definable problem that needs a legislative or regulatory solution. It, too, has more implications in the Consumer market, but could affect the RBOCs' ability to offer advanced services to Web-centric business customers. Finally, reform of the universal service is a legislative and regulatory priority, but it has limited implications in the provision of Business Services.

Although the current telecom regulatory environment is favorable, in our view, a shift in control of the House or Senate would not create a material legislative overhang.

Media reports have recently concluded that the Democrats' prospects in the November elections have improved and they could gain control of the House and/or Senate. Although the current telecom regulatory environment is favorable, in our view, a shift in control of the House or Senate would not create a material legislative overhang. Network neutrality has emerged as one issue that could receive additional traction in a Democrat-controlled Congress. However, we do not expect legislation to pass that is materially adverse to the RBOCs on the issue, for several reasons: First, problems related to discriminatory access to the public networks have been rare. Second, although the network neutrality debate has risen in prominence recently, communications legislation will likely encompass a broad range of issues including universal service and video franchising, making consensus among lawmakers difficult to achieve. Third, this debate has joined traditional antagonists—the RBOCs and the cable industry.

We believe telecommunications issues are not traditionally debated along party lines. For example, universal service policy debates are generally between members with urban and rural constituents. Additionally, as illustrated in Figure 20 the RBOCs have formidable employee bases and capital spending programs that generally ensure decent treatment in Washington, DC.

Figure 20: The RBOCs' Diverse Employee Footprints and Capex Profiles

	AT&T/ BellSouth	Verizon	Qwest	Google	Microsoft	Yahoo!
US Employees	260,000	250,000	40,000	9,000	44,000	10,400
International					27,000	
2006 Capex (millions)	$ 19,618	$ 17,105	$ 1,675	$ 2,200	$ 1,600	$ 730
States with Significant Ops	25	30	28			
Local Telephone Operations	21	28	14			
Out of Region Enterprise Operations	4	2	10			
Congressional Districts with Material Employment	244	166	75			

Source: Company documents and Lehman Brothers estimates

Regulatory

We believe that local access to ILEC networks is the most significant regulatory issue facing competitors in the Business Services marketplace.

We believe that local access to ILEC networks is the most significant regulatory issue facing competitors in the Business Services marketplace. However, recent regulatory and judicial decisions have produced what we believe will likely be long-term access to local loops. As noted above, the RBOCs face a significant cost advantage within their ILEC footprints because they do not pay local loop fees to reach their customers. In December 2004, the FCC adopted its fourth set of rules concerning an ILEC's obligation to make elements of its network available to other local service providers, after three previous sets of rules had been overturned by the federal courts. In February 2005, the FCC released its written order containing the new rules, and the Triennial Review Remand Order (TRRO) became effective in March 2005. The TRRO provides significant relief from unbundling by eliminating an incumbent local exchange carrier's remaining obligation to provide local switching, and hence the UNE-P, for mass-market customers. At the same time, the TRRO largely retained unbundling requirements for many high-capacity loop and transport facilities. Several ILECs, including AT&T, appealed the unbundling requirements for high-capacity loop and transport facilities. In June 2006, the D.C. Circuit Court issued a decision upholding the TRRO in all respects. The D.C. Circuit Court's decision became final in September 2006 and provides clarity on RBOC requirements to provide unbundled access to their networks.

In early September 2006, Verizon asked the FCC to remove DS1 and DS3 loop and transport facilities from the list of unbundled network elements it must offer competing voice providers, especially cable companies. Verizon is arguing that it is no longer the "dominant carrier" in five major metro areas—Boston, New York, Philadelphia, Virginia Beach, and Providence, Rhode Island. Verizon says it is facing "facilities-based" competition from cable, wireless, "over-the-top VOIP," and wholesale voice providers. Verizon claims its cable, wireless, and wholesale competitors are unfairly relying on access to local loops to compete for enterprise customers. If the FCC agrees, Verizon would no longer be subject to the pricing caps imposed on the "dominant carrier" in a given market when selling wholesale access to its exchange facilities. In theory, Verizon could then increase rates for access to its DS1 and DS3 loops. Verizon is basing its request on similar forbearance Qwest received in Omaha, Nebraska. According to Verizon, competition has increased dramatically since the dominant carrier rules were written. The FCC has 12 months to hold a majority vote on the issue. If it does not do so, forbearance is granted automatically.

Earlier this year, the FCC automatically granted similar forbearance for more sophisticated optical-based services in some of Verizon's markets when it failed to vote on Verizon's request. We believe a similar outcome is unlikely. The commission has indicated in the past that access to local loops and interoffice transport encourages competition and adequately compensates the ILECs. In our opinion, the FCC could issue a narrow approval of the request in markets where sufficient facilities-based alternatives exist, which would not harm the competitive dynamic.

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Important Disclosures:

Other Material Conflicts

AT&T (T): Lehman Brothers is acting as financial advisor to AT&T on the potential acquisition of BellSouth.

BellSouth Corp (BLS): Lehman Brothers is acting as financial advisor to AT&T on the potential acquisition of BellSouth.

Verizon Communications (VZ): Lehman Brothers is acting as exclusive financial advisor to Verizon in connection with the sale of its Latin American / Caribbean businesses to America Movil and Telmex.

Sector Coverage Universe

Below is the list of companies that constitute the sector coverage universe:

Alaska Communications Systems (ALSK)
BellSouth Corp (BLS)
Citizens Communications (CZN)
Commonwealth Telephone Enterprises (CTCO)
Embarq (EQ)
FairPoint Communications (FRP)
Qwest Commu Int'l (Q)
Time Warner Telecom (TWTC)
Windstream Corporation (WIN)
AT&T (T)
CenturyTel, Inc (CTL)
Cogent Communications Group (CCOI)
Consolidated Communications (CNSL)
Eschelon Telecom (ESCH)
Iowa Telecommunications (IWA)
Telephone & Data Systems (TDS)
Verizon Communications (VZ)

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Our coverage analysts use a relative rating system in which they rate stocks as 1-Overweight, 2-Equal weight or 3-Underweight (see definitions below) relative to other companies covered by the analyst or a team of analysts that are deemed to be in the same industry sector ("the sector coverage universe"). To see a list of companies that comprise a particular sector coverage universe, please go to www.lehman.com/disclosures.

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Stock Ratings:

1-Overweight - the stock is expected to outperform the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

2-Equal weight - the stock is expected to perform in line with the unweighted expected total return of the sector coverage universe over a 12-month investment horizon.

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