

MCLEODUSA INC  
Form 10-Q  
August 09, 2005

**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the Quarterly Period Ended June 30, 2005

or

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

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

Commission file number 0-20763

**MCLEODUSA INCORPORATED**

(Exact name of registrant as specified in its charter)

Delaware  
(State of Incorporation)

McLeodUSA Technology Park  
6400 C Street SW  
P.O. Box 3177

42-1407240  
(IRS Employer Identification No.)

52406-3177

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**Cedar Rapids, Iowa**  
(Address of principal executive office)

(Zip Code)

**319-364-0000**  
(Registrant's telephone number,  
including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes  No

The number of shares outstanding of each class of the issuer's common stock as of July 31, 2005:

|  |                    |
|--|--------------------|
| Common Stock Class A: (\$0.01 par value) | 201,685,063 shares |
| Common Stock Class B: (\$0.01 par value) | 78,203,135 shares  |
| Common Stock Class C: (\$0.01 par value) | 35,546,879 shares  |

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

## McLEODUSA INCORPORATED AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions, except share data)

|  | June 30,<br>2005 | December 31,<br>2004 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| Current assets   |                  |                      |
| Cash and cash equivalents  | \$ 33.4          | \$ 50.0              |
| Trade receivables, net   | 54.9             | 58.6                 |
| Prepaid expenses and other   | 14.7             | 19.9                 |
| Total current assets   | 103.0            | 128.5                |
| Property and equipment   |                  |                      |
| Land and buildings   | 57.0             | 76.4                 |
| Communications networks  | 1,007.3          | 1,116.4              |
| Furniture, fixtures and equipment  | 191.7            | 204.5                |
| Networks in progress   | 26.3             | 51.3                 |
| Total property and equipment   | 1,282.3          | 1,448.6              |
| Less accumulated depreciation  | 827.9            | 719.9                |
| Net property and equipment   | 454.4            | 728.7                |
| Intangibles and other assets   |                  |                      |
| Other intangibles, net   | 98.2             | 144.9                |
| Other  | 18.4             | 23.7                 |
| Total intangibles and other assets   | 116.6            | 168.6                |
| <b>TOTAL ASSETS</b>  | <b>\$ 674.0</b>  | <b>\$ 1,025.8</b>    |
| <b>LIABILITIES AND STOCKHOLDERS DEFICIENCY</b>   |                  |                      |
| Current liabilities  |                  |                      |
| Current maturities of long-term debt   | \$ 777.3         | \$ 49.5              |
| Accounts payable   | 36.7             | 39.6                 |
| Accrued payroll and payroll related expenses   | 14.7             | 19.7                 |
| Other accrued liabilities  | 95.3             | 75.4                 |
| Deferred revenue, current portion  | 6.8              | 6.8                  |
| Total current liabilities  | 930.8            | 191.0                |
| Long-term debt, less current maturities  |                  |                      |
| Deferred revenue, less current portion   | 17.9             | 17.0                 |
| Other long-term liabilities  | 62.3             | 61.4                 |
| Total liabilities  | 1,011.0          | 997.2                |
| Redeemable convertible preferred stock   |                  |                      |
| McLeodUSA Preferred Series A, redeemable, convertible, \$0.01 par value; 10,000,000 authorized and issued; 2,320,480 and 4,131,336 outstanding at June 30, 2005 and December | 43.0             | 75.4                 |

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31, 2004, respectively

|   |                 |                   |
|---|-----------------|-------------------|
| Stockholders' equity  |                 |                   |
| McLeodUSA Common, Class A \$0.01 par value; 1,886,249,986 authorized, 201,685,063 and 192,227,818 issued and outstanding at June 30, 2005 and December 31, 2004, respectively | 2.0             | 1.9               |
| McLeodUSA Common, Class B \$0.01 par value; 78,203,135 authorized, issued and outstanding at June 30, 2005 and December 31, 2004  | 0.8             | 0.8               |
| McLeodUSA Common, Class C \$0.01 par value; 35,546,879 authorized, issued and outstanding at June 30, 2005 and December 31, 2004  | 0.3             | 0.3               |
| McLeodUSA Preferred Series B, \$0.01 par value; 10 authorized, issued and outstanding at June 30, 2005 and December 31, 2004  |                 |                   |
| McLeodUSA Warrants  | 22.6            | 22.6              |
| Additional paid-in capital  | 1,081.4         | 1,049.2           |
| Accumulated deficit   | (1,487.1)       | (1,121.6)         |
| Total stockholders' deficiency  | (380.0)         | (46.8)            |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' DEFICIENCY</b>   | <b>\$ 674.0</b> | <b>\$ 1,025.8</b> |

The accompanying notes are an integral part of these condensed consolidated financial statements

## MCLEODUSA INCORPORATED AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except per share data)

|   | Three months ended June 30, |                  |
|---|-----------------------------|------------------|
|   | 2005                        | 2004             |
| Revenue   | \$ 159.7                    | \$ 191.9         |
| Operating expenses:   |                             |                  |
| Cost of service (exclusive of depreciation and amortization shown separately below) | 92.2                        | 105.3            |
| Selling, general and administrative   | 53.7                        | 68.5             |
| Depreciation and amortization   | 54.5                        | 88.4             |
| Impairment charge   | 202.5                       |                  |
| Restructuring charges (adjustment)  | 4.8                         | (0.2)            |
| <b>Total operating expenses</b>   | <b>407.7</b>                | <b>262.0</b>     |
| <b>Operating loss</b>   | <b>(248.0)</b>              | <b>(70.1)</b>    |
| Nonoperating expense:   |                             |                  |
| Interest expense, net of amounts capitalized  | (19.5)                      | (11.6)           |
| Other expense   | (0.5)                       | (0.5)            |
| <b>Total nonoperating expense</b>   | <b>(20.0)</b>               | <b>(12.1)</b>    |
| <b>Net loss</b>   | <b>(268.0)</b>              | <b>(82.2)</b>    |
| Preferred stock dividend  | (0.4)                       | (0.8)            |
| <b>Net loss applicable to common shares</b>   | <b>\$ (268.4)</b>           | <b>\$ (83.0)</b> |
| <b>Basic and diluted loss per common share</b>                                      | <b>\$ (0.86)</b>            | <b>\$ (0.28)</b> |
| <b>Weighted average common shares outstanding</b>                                   | <b>313.2</b>                | <b>292.2</b>     |

The accompanying notes are an integral part of these condensed consolidated financial statements.



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|   | Six months ended June 30, |                   |
|---|---------------------------|-------------------|
|   | 2005                      | 2004              |
| Revenue   | \$ 320.2                  | \$ 385.5          |
| Operating expenses:   |                           |                   |
| Cost of service (exclusive of depreciation and amortization shown separately below) | 185.5                     | 212.9             |
| Selling, general and administrative   | 110.4                     | 144.2             |
| Depreciation and amortization   | 145.8                     | 178.6             |
| Impairment charge   | 202.5                     |                   |
| Restructuring charges (adjustment)  | 6.9                       | (0.2)             |
| <b>Total operating expenses</b>   | <b>651.1</b>              | <b>535.5</b>      |
| <b>Operating loss</b>   | <b>(330.9)</b>            | <b>(150.0)</b>    |
| Nonoperating expense:   |                           |                   |
| Interest expense, net of amounts capitalized  | (33.9)                    | (22.8)            |
| Other expense   | (0.8)                     | (0.9)             |
| <b>Total nonoperating expense</b>   | <b>(34.7)</b>             | <b>(23.7)</b>     |
| <b>Net loss</b>   | <b>(365.6)</b>            | <b>(173.7)</b>    |
| Preferred stock dividend  | (0.8)                     | (1.6)             |
| <b>Net loss applicable to common shares</b>   | <b>\$ (366.4)</b>         | <b>\$ (175.3)</b> |
| <b>Basic and diluted loss per common share</b>                                      | <b>\$ (1.18)</b>          | <b>\$ (0.60)</b>  |
| <b>Weighted average common shares outstanding</b>                                   | <b>310.8</b>              | <b>291.6</b>      |

The accompanying notes are an integral part of these condensed consolidated financial statements.

## McLEODUSA INCORPORATED AND SUBSIDIARIES

## UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

|   | Six months ended June 30, |               |
|---|---------------------------|---------------|
|   | 2005                      | 2004          |
| <b>Cash Flows from Operating Activities</b>   |                           |               |
| Net loss  | \$ (365.6)                | \$ (173.7)    |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities: |                           |               |
| Depreciation  | 117.1                     | 150.0         |
| Amortization  | 28.7                      | 28.6          |
| Accretion of interest   | 1.9                       | 1.8           |
| Amortization of deferred financing fees   | 2.3                       | 2.0           |
| Loss on sale of assets  | 1.0                       | 1.0           |
| Impairment charge   | 202.5                     |               |
| Changes in assets and liabilities:  |                           |               |
| Trade receivables   | 2.7                       | (1.9)         |
| Prepaid expenses and other  | 1.8                       | 1.4           |
| Accounts payable and accrued expenses   | 11.4                      | (12.7)        |
| Deferred revenue  | 0.9                       | 1.1           |
| <b>Net cash provided by (used in) operating activities</b>                                | <b>4.7</b>                | <b>(2.4)</b>  |
| <b>Cash Flows from Investing Activities</b>   |                           |               |
| Purchases of property and equipment   | (21.0)                    | (26.9)        |
| Other assets  | (13.7)                    | (14.8)        |
| Proceeds from the sale of assets  | 13.4                      | 7.1           |
| <b>Net cash used in investing activities</b>  | <b>(21.3)</b>             | <b>(34.6)</b> |
| <b>Cash Flows from Financing Activities</b>   |                           |               |
| Net proceeds from long-term debt  |                           | 25.0          |
| Payments on long-term debt  |                           | (11.4)        |
| Deferred financing fees   |                           | (1.9)         |
| <b>Net cash provided by financing activities</b>  |                           | <b>11.7</b>   |
| <b>Net decrease in cash and cash equivalents</b>  | <b>(16.6)</b>             | <b>(25.3)</b> |
| <b>Cash and cash equivalents</b>  |                           |               |
| Beginning   | 50.0                      | 56.5          |
| Ending  | \$ 33.4                   | \$ 31.2       |
| <b>Supplemental Disclosure of Cash Flow Information</b>                                   |                           |               |
| Cash payments for interest  | \$ 3.7                    | \$ 20.2       |
| <b>Supplemental Schedule of Noncash Investing and Financing Activities</b>                |                           |               |
| Principal amount converted of Redeemable Preferred Series A to Class A common stock       | \$ 33.2                   | \$ 11.0       |
| Accrued capital expenditures  | \$ 0.9                    | \$ 0.8        |
| Preferred stock dividends   | \$ 0.8                    | \$ 1.6        |

The accompanying notes are an integral part of these condensed consolidated financial statements.



**MCLEODUSA INCORPORATED AND SUBSIDIARIES**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1: Basis of Presentation**



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McLeodUSA Incorporated ( McLeodUSA or the Company ), a Delaware corporation, through its subsidiaries, provides integrated communications services in 25 Midwest, Southwest, Northwest and Rocky Mountain states. McLeodUSA's business is highly competitive and is subject to various federal, state and local regulations.

### Overview

In the fourth quarter of 2001, the Company developed a revised strategic plan, which focused on profitable revenue growth in our 25-state footprint. In order to execute its plan the Company initiated a variety of programs across the business to significantly improve the customer experience, eliminate unneeded infrastructure and cost, improve the quality of the network and grow the top line revenues. Over the past several years the Company has successfully executed nearly all of these programs. The operational and certain financial results of the Company, as reported in its quarterly and annual financial releases, reflect the significant progress that has been made in the operational areas.

However, the Company's revenues have not increased as forecasted and have been declining since 2002. The decline in revenue was driven by the Company's program to eliminate non-profitable customers, turnover of customers to competitors in excess of new customers acquired, reduction in access rates as mandated by the Federal Communications Commission ( FCC ), and lower prices for some of its products. The Company has taken significant actions to increase revenue, including introduction of new competitively priced products, reorganization of the sales operation, expanding the involvement of the board of directors and executive staff in the sales process and reducing customer churn. To date, these actions have not resulted in profitable new revenue growth which continues to be a challenge as the Company competes against large, financially strong competitors with well-known brands. With the pending mergers in the industry, the Company believes that the large telecommunications providers will likely become even more aggressive upon the closing of these transactions further challenging the Company's ability to grow revenue.

In light of the inability of the Company to achieve new revenue growth in excess of existing customer turnover and ultimately generate enough operating cash flow to service the existing level of debt, the Company's Board of Directors authorized the Company to pursue strategic alternatives. Over the past several months the Company has been actively pursuing a strategic partner or a sale of the Company while also taking steps to maintain future liquidity, including evaluating a capital restructuring to reduce the current debt level, enabling the Company to achieve positive cash flow going forward.

The Company has undertaken numerous actions to conserve cash, including the reduction of capital expenditures and selling, general and administrative expenses ( SG&A ), as well as the execution of extensive cost reduction efforts initiated in late 2001 and continuing through today. These actions have resulted in a 22% reduction in SG&A expenses from the same quarter of last year. The Company has been selective in managing capital expenditures and does not believe that any of the reductions in capital spending will have a material impact on its ability to services its customers.

In light of the level of cash held by the Company at December 31, 2004 and the payments required during the first quarter of 2005 under its Credit Agreement dated May 31, 2000, as amended (the Credit Agreement ) and its Exit Credit Agreement, dated April 16, 2002, as amended, (the Exit Facility or collectively, the Credit Facilities ), the Company began discussions with its agent bank and a group of lenders acting as a steering committee for the lenders under its Credit Facilities. The Company entered a forbearance agreement on March 16, 2005 with its lenders whereby the lenders agreed not to take any action as a result of non-payment by the Company of scheduled principal amortization payments under the Credit Facilities and interest payments under the Credit Agreement and any related events of default. The initial forbearance agreement expired on May 23, 2005 but has since been extended until September 9, 2005. The forbearance agreement, among other things, limits the Company's ability to sell certain assets without prior approval of the lender group and requires McLeodUSA to accrue two additional percentage points of interest on the outstanding loan balances. In accordance with the forbearance agreement, as of June 30, 2005, the Company has elected not to make \$15.6 million of scheduled principal payments and \$23.1 million of scheduled interest payments. The Company believes that by not making principal and interest payments on the Credit Facilities, cash on hand together with cash flows from operations is sufficient to maintain operations in the ordinary course without disruption of services.



At this time, the Company has concluded that there is not an acceptable strategic partner or buyer and is proceeding to work with its lenders to complete a capital restructuring where the lenders would convert a substantial portion of their debt to equity and become the stockholders of the Company. There can be no assurance that the Company will be able to reach an agreement with its lenders regarding a capital restructuring or continued forbearance and covenant relief prior to the end of the current forbearance period on September 9, 2005. In the event that the Company cannot reach an agreement with its lender group, it is likely that the Company will elect to forgo making future principal and interest payments to its lenders while it continues to seek an extended forbearance period or permanent capital restructuring from its lenders, or alternatively, the Company could be forced to seek protection from its creditors.

While the Company continues to explore with its lenders a capital restructuring, none of the alternatives presented to date have suggested that there will be any recovery for the Company's current preferred stock or common stockholders. Accordingly, the Company does not expect the holders of its preferred or common stock to receive any recovery in a capital restructuring.

The Company's financial statements for the period ending June 30, 2005 and December 31, 2004 are prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business, but the Company may not be able to continue as a going concern. The report of McLeodUSA's independent registered public accounting firm accompanying its financial statements in its Annual Report on 10-K filed with the Securities and Exchange Commission (SEC) on March 25, 2005, contains a comment stating that there is substantial doubt as to its ability to continue as a going concern. In the event the Company's capital restructuring activities are not successful and it is required to seek protection from its creditors, additional significant adjustments to the Company's consolidated financial statements may be necessary.

#### **Interim Financial Information (unaudited)**

In the opinion of management, the accompanying unaudited condensed consolidated financial statements include adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of the financial position and results of operations of McLeodUSA. The operating results for the interim periods are not necessarily indicative of the operating results to be expected for a full year or for other interim periods. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to instructions, rules and regulations prescribed by the SEC. Although management believes that the disclosures provided are adequate to make the information presented not misleading, management recommends that you read these unaudited condensed consolidated financial statements in conjunction with the audited consolidated financial statements and the related footnotes included in the McLeodUSA Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the SEC on March 25, 2005.

Certain prior period amounts in the consolidated statements of cash flows have been reclassified to conform to current year presentation.

#### **Accounting for Stock-based Compensation**



As permitted by Statement of Financial Accounting Standards ( SFAS ) No. 123, *Accounting for Stock-Based Compensation* ( SFAS 123 ), McLeodUSA measures compensation using the intrinsic value based method as prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, but is required to make proforma disclosures in the footnotes to the financial statements as if the measurement provisions of SFAS 123 and SFAS No. 148 *Accounting for Stock-Based Compensation-Transition and Disclosure an Amendment of SFAS 123* had been adopted. Under the intrinsic value method, compensation is measured as the difference between the market value of the stock on the grant date, less the amount required to be paid for the stock. The difference, if any, is charged to expense over the vesting period of the options. No stock-based employee compensation cost is reflected in net loss, as all options granted under the plan had an exercise price greater than or equal to the market value of the underlying common stock on the date of grant.

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The following table illustrates the effect on net loss and net loss per share for the three and six months ended June 30, 2005 and 2004 as if McLeodUSA had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation.

|   | <b>Three months ended June 30,</b> |             |
|---|------------------------------------|-------------|
|   | <b>2005</b>                        | <b>2004</b> |
| Net loss applicable to common shares, as reported   | \$ (268.4)                         | \$ (83.0)   |
| Less: Total stock-based employee compensation expense determined under fair value based methods | (1.0)                              | (3.2)       |
| Pro forma net loss applicable to common shares  | \$ (269.4)                         | \$ (86.2)   |
| <b>Loss per share:</b>  |                                    |             |
| Basic and diluted, as reported  | \$ (0.86)                          | \$ (0.28)   |
| Basic and diluted, pro forma  | \$ (0.86)                          | \$ (0.29)   |

|   | <b>Six months ended June 30,</b> |             |
|---|----------------------------------|-------------|
|   | <b>2005</b>                      | <b>2004</b> |
| Net loss applicable to common shares, as reported   | \$ (366.4)                       | \$ (175.3)  |
| Less: Total stock-based employee compensation expense determined under fair value based methods | (2.9)                            | (6.5)       |
| Pro forma net loss applicable to common shares  | \$ (369.3)                       | \$ (181.8)  |
| <b>Loss per share:</b>  |                                  |             |
| Basic and diluted, as reported  | \$ (1.18)                        | \$ (0.60)   |
| Basic and diluted, pro forma  | \$ (1.19)                        | \$ (0.62)   |

**Basic and diluted loss per common share**

Loss per common share has been computed using the weighted average number of shares of common stock outstanding. All stock options granted, and the convertible preferred stock and warrants outstanding are anti-dilutive, and are therefore excluded from the computation of earnings per share. In the future, the stock options, convertible preferred stock and warrants totaling approximately 102 million shares and 136 million shares at June 30, 2005 and 2004, respectively, may become dilutive. Assuming exercise or conversion of stock options and convertible securities, diluted shares would have been approximately 417 million and 429 million at June 30, 2005 and 2004, respectively.

**New accounting pronouncement**



In December 2004, the Financial Accounting Standards Board revised and reissued SFAS 123 as SFAS 123(R), *Accounting for Stock Issued to Employees* ( SFAS 123(R) ). This statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will then be recognized as compensation cost over the period during which an employee is required to provide service in exchange for the award. The provisions of this statement are effective for McLeodUSA January 1, 2006. McLeodUSA is still evaluating the impact that SFAS 123(R) will have on its financial position and results of operations but expects that the disclosure above, adjusted for estimated forfeitures, provides a reasonable measure of the expected impact.



**Guarantees**



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In November 2002, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 45, *Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This interpretation clarifies disclosures that are required to be made by a guarantor in its interim and annual financial statements about obligations under certain of its issued guarantees. In addition, the interpretation clarifies that a guarantor is required to recognize, at the inception of certain types of guarantees, a liability for the fair value of the obligation undertaken in issuing these guarantees. At June 30, 2005, McLeodUSA, the parent company, has various guarantees related to subsidiary commitments under operating leases. As of June 30, 2005 the guarantees total \$22.2 million and expire over various periods through September 2016, corresponding with the termination of the lease agreements.



McLeodUSA has indemnification obligations to its current and former Directors and Officers. The terms of the indemnification obligations provide for no limitation to the maximum potential future payments under such indemnifications. McLeodUSA maintains insurance, subject to limitations set forth in the policies, which is intended to cover the costs of claims made against its Directors and Officers.

McLeodUSA entered into an executive employment agreement with its Chief Executive Officer, Chris A. Davis, as of October 14, 2004. Under the agreement, McLeodUSA has agreed to make equalization payments, as necessary, to offset any reduction in certain annual cash compensation currently received by Ms. Davis from Forstmann Little. The amount of such equalization payments is not to exceed \$500,000 annually. McLeodUSA will begin making the equalization payments in quarterly installments during the third quarter of 2005.

**Note 2: Trade Receivables**

The composition of trade receivables, net, is as follows (in millions):

|   | <b>June 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|---|--------------------------|------------------------------|
| <b>Trade Receivables:</b>                     |                          |                              |
| Billed  | \$ 60.7                  | \$ 66.3                      |
| Unbilled                                      | 4.7                      | 4.8                          |
|   | 65.4                     | 71.1                         |
| Allowance for doubtful accounts and discounts | (10.5)                   | (12.5)                       |
|   | \$ 54.9                  | \$ 58.6                      |

**Note 3: Other Accrued Liabilities**

Other accrued liabilities consisted of the following (in millions):

|                                | <b>June 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|--------------------------------|--------------------------|------------------------------|
| Accrued interest               | \$ 28.2                  | \$ 1.8                       |
| Accrued sales/use/excise taxes | 16.8                     | 17.8                         |
| Restructuring                  | 10.0                     | 15.2                         |
| Accrued property taxes         | 8.3                      | 10.9                         |
| Other                          | 32.0                     | 29.7                         |
|                                | \$ 95.3                  | \$ 75.4                      |

As discussed in Note 1, the Company elected not to make certain interest payments in accordance with the forbearance agreement. As a result of the non-payment, an event of default occurred and the Company is required to accrue two additional percentage points of interest on the Credit Facilities as provided in the forbearance agreement.

**Note 4: Restructuring Charges**



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The Company incurred charges of \$4.8 million and \$6.9 million for the three and six months ending June 30, 2005, respectively, related to financial and legal advisors supporting the Company's pursuit of strategic alternatives and financial restructuring.

Changes in the carrying amount of the restructuring liability for the six months ended June 30, 2005 is summarized as follows (in millions):

| <b>Facility closure costs</b> |    |       |
|-------------------------------|----|-------|
| Balance, December 31, 2004    | \$ | 15.2  |
| Payments                      |    | (5.2) |
| Balance, June 30, 2005        | \$ | 10.0  |

**Note 5: Impairment charges**

In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ( *SFAS 144* ), a long-lived asset group shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. As discussed in Note 1, the Company has concluded that there is not an acceptable strategic partner or buyer at this time and the Company is proceeding to work with its lender group to complete a capital restructuring. As a result, the Company performed an evaluation of the recoverability of its property and equipment which indicated that certain of its long-lived assets were impaired. The Company used a probability-weighted discounted cash flow analysis to estimate the fair value of the Company's property and equipment and recorded a non-cash impairment charge of \$174.8 million to reduce the carrying amount to estimated fair value.

In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* ( *SFAS 142* ), indefinite-lived intangible assets are not to be amortized but reviewed annually for impairment or more frequently if an event occurs or circumstances change that would more likely than not reduce the fair value below its carrying amount. As a result of the potential capital restructuring discussed above, the Company performed an evaluation on the McLeodUSA trade name utilizing a relief from royalty method of valuation. The evaluation indicated an impairment of \$27.7 million on the McLeodUSA trade name to reduce its carrying value to estimated fair value of \$37.2 million. Consequently, the Company has recorded a non-cash impairment charge totaling \$202.5 million, to include the impairment on both the property and equipment and the McLeodUSA trade name, in its statement of operations for the three and six months ended June 30, 2005.

**Note 6: Other Intangible Assets**



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The McLeodUSA trade name was evaluated for impairment in conjunction with the preparation of the June 30, 2005 financial statements. This evaluation indicated partial impairment in the McLeodUSA trade name and the Company has reduced the carrying value of the McLeodUSA trade name to \$37.2 million.

Intangible assets with finite lives at June 30, 2005 and December 31, 2004 are summarized as follows (in millions):

|                                  | Gross    | Accumulated<br>Amortization | Net     |
|----------------------------------|----------|-----------------------------|---------|
| <b>June 30, 2005:</b>            |          |                             |         |
| Deferred line installation costs | \$ 199.6 | \$ 147.4                    | \$ 52.2 |
| Customer base                    | 24.0     | 15.4                        | 8.6     |
| PrimeLine Trademark              | 0.9      | 0.7                         | 0.2     |
|                                  | \$ 224.5 | \$ 163.5                    | \$ 61.0 |

|                                  | Gross    | Accumulated<br>Amortization | Net     |
|----------------------------------|----------|-----------------------------|---------|
| <b>December 31, 2004:</b>        |          |                             |         |
| Deferred line installation costs | \$ 190.5 | \$ 121.9                    | \$ 68.6 |
| Customer base                    | 29.8     | 18.7                        | 11.1    |
| PrimeLine Trademark              | 0.9      | 0.6                         | 0.3     |
|                                  | \$ 221.2 | \$ 141.2                    | \$ 80.0 |

Annual estimated amortization expense for intangible assets above for 2005 is \$24 million, \$30 million for 2006, and \$7 million for 2007.

**Note 7: Accounting for Asset Retirement Obligations**

SFAS No. 143, *Accounting for Asset Retirement Obligations* ( SFAS 143 ), requires entities to record the fair value of a liability for an asset retirement obligation in the period in which the legal or contractual removal obligation is incurred. McLeodUSA's asset retirement obligations relate to three categories of assets: fiber, central office colocation equipment and technical sites.

The liability was established by calculating the present value of the asset retirement obligation using a discount rate of 6.1% over a period of 15 years, which is representative of the estimated life of McLeodUSA's telecommunications network.

Changes in the carrying amount of the asset retirement obligation for the six months ended June 30, 2005 is summarized as follows (in millions):

|                            |    |       |
|----------------------------|----|-------|
| Balance, December 31, 2004 | \$ | 61.4  |
| Interest accretion         |    | 1.9   |
| Payments                   |    | (0.2) |
| Adjustments                |    | (0.8) |
| Balance, June 30, 2005     | \$ | 62.3  |

**Note 8: Long Term Debt**





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On March 16, 2005, McLeodUSA and certain of its subsidiaries entered into a forbearance agreement with JPMorgan Chase Bank, N.A., as administrative agent related to the Credit Agreement and Exit Facility. Pursuant to the forbearance agreement, the lenders have agreed to forbear from exercising any remedies as a result of certain specified defaults under the Credit Facilities anticipated by the Company during the forbearance period, including, without limitation, the failure to make scheduled amortization payments under the Credit Facilities and interest payments under the Credit Agreement. The initial forbearance agreement expired on May 23, 2005 but has since been extended to September 9, 2005. At this time, the Company has concluded that there is not an acceptable strategic partner or buyer and is proceeding to work with its lenders to complete a capital restructuring where the lenders would convert a substantial portion of their debt to equity and become the stockholders of the Company. There can be no assurance that the Company will be able to reach an agreement with its lenders regarding a capital restructuring or continued forbearance and covenant relief prior to the end of the forbearance period on September 9, 2005.

In accordance with the forbearance agreement, as of June 30, 2005, the Company has elected not to make \$15.6 million of scheduled principal amortization and \$23.1 million of scheduled interest payments. The forbearance agreement, among other things, limits the Company's ability to sell certain assets without prior approval of the lender group and requires the Company to accrue two additional percentage points of interest on the outstanding loan balance. The Company's debt has been classified as current in the condensed consolidated balance sheet because the default is not expected to be cured by September 9, 2005, the date the forbearance agreement ends, and the forbearance agreement does not extend beyond one year from the balance sheet date.

### **Note 9: Litigation**

Former Chairman Clark E. McLeod, former President Stephen C. Gray (then also Chief Executive Officer), Chairman and Chief Executive Officer Chris A. Davis (then Chief Operating and Financial Officer) and former Chief Financial and Accounting Officer J. Lyle Patrick (the

Individual Defendants) are defendants in a consolidated class action entitled In re McLeodUSA Incorporated Securities Litigation, Civil Action No. C02-0001 (N.D. Iowa) (the Iowa Class Action), alleging inter alia, violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Individual Defendants moved to dismiss the consolidated amended complaint in the Iowa Class Action. That motion was denied. Discovery is ongoing. One of the putative class plaintiffs, New Millennium Growth Fund LLC, also filed proofs of claim against McLeodUSA in McLeodUSA's Chapter 11 Case, seeking at least \$104,650 on its own behalf and no less than approximately \$300 million (plus interest, costs and attorneys' fees as allowed) on behalf of all class claimants in the Iowa Class Action (the Bankruptcy Claims and, together with the Iowa Class Action, the Securities Claims). The Bankruptcy Claims were transferred from the bankruptcy court in Delaware to the Iowa court, and consolidated with the Iowa Class Action on February 1, 2005. As the Securities Claims are in early stages, it is impossible to evaluate the likelihood of unfavorable outcomes or, with respect to McLeodUSA's indemnification obligations in connection with the

claims alleged against the Individual Defendants in the consolidated amended complaint, estimate the amount or range of potential loss, if any, to McLeodUSA. With respect to the Bankruptcy Claims, on May 2, 2002, the Bankruptcy Court issued an order establishing a disputed claims reserve of 18,000,000 shares of Reorganized McLeodUSA Class A Common Stock. Any recovery from the Bankruptcy Claims would be limited to those shares of stock. McLeodUSA believes that the Securities Claims are without merit and intends to defend them vigorously.

McLeodUSA has indemnification obligations running to the Individual Defendants, the terms of which provide for no limitation to the maximum potential future payments under such indemnifications. McLeodUSA is unable to develop an estimate of the maximum potential amount of future payments under the indemnifications due to the inherent uncertainties involved in such litigation. McLeodUSA maintains insurance, subject to limitations set forth in the policies, which is intended to cover the costs of claims made against its current and former Directors and Officers, including the Individual Defendants.

McLeodUSA is also involved in numerous regulatory proceedings before various public utility commissions and the FCC, particularly in connection with actions by the Regional Bell Operating Companies ( RBOCs ). McLeodUSA anticipates the RBOCs will continue to pursue litigation, regulations and legislation in states within McLeodUSA's 25-state footprint and with the FCC to reduce regulatory oversight and regulation over rates, network access and operations. The RBOCs are also actively pursuing major changes in the Telecommunications Act of 1996 ( 1996 Act ), by regulatory litigation and legislation, which McLeodUSA believes would adversely affect competitive telecommunications service providers including McLeodUSA. If adopted, these changes could make it more difficult for McLeodUSA to challenge the RBOCs' actions, or to compete with the RBOCs, in the future. There are no assurances that McLeodUSA will prevail in its disputes with the RBOCs.

The FCC released its Triennial Review Order ( TRO ) in August 2003 modifying its rules governing availability of RBOC unbundled network elements to competitive carriers. The Triennial Review Order established new rules governing the availability and pricing for the network elements the RBOCs must provide to competitive carriers, and delegated authority to the states to apply certain of the new rules in individual markets. Several appeals of the TRO were consolidated in the Court of Appeals for the District of Columbia (the Court of Appeals ). On March 2, 2004, the Court of Appeals issued a decision overturning many key elements of the TRO, remanding most of the order to the FCC for further action ( *USTA II* ). The Court of Appeals ruled that the FCC's delegation of final impairment decisions to state agencies was unlawful. The Court also reversed the FCC's nationwide finding regarding mass market switching, dedicated transport and its delegation of decision-making authority to the states. The Court directed the FCC to give stronger consideration to intermodal competition when revising its rules on remand. The Court upheld the FCC determination that RBOCs do not have to provide unbundled access at current prices to newly deployed technologies based on fiber and packet-switching capabilities. The Court also upheld the FCC's findings that RBOCs are not required to provide unbundled switching to CLECs for business customers served by high-capacity loops, such as DS-1 or packet switching. State proceedings that had been started to implement the TRO were suspended in some states and continued in other states. The FCC and U. S. Department of Justice declined to appeal *USTA II*. Competitive and interexchange carriers and an organization representing state regulatory agencies filed appeals to the U.S. Supreme Court and requested a stay. The U.S. Supreme Court declined to issue a stay. On July 22, the FCC adopted and on August 22, 2004, the FCC released an Interim UNE Order (the Interim Order ) establishing requirements that govern the availability of UNEs until the FCC adopts new, permanent unbundling rules. On December 15, 2004, the FCC announced adoption of revised permanent unbundling rules that it believes are in compliance with prior appellate decisions. These new unbundling rules impact access to local switching, high capacity loops, high capacity transport, dark fiber, and entrance facilities. The FCC also adopted a transition plan for those elements that will no longer be UNEs. The Company believes that the new rules are predominantly supportive of its facilities-based (UNE-L) strategy. The new unbundling rules became effective March 11, 2005.

Regardless of the success, or lack of success, of commercial negotiations with Qwest and SBC and adoption of final unbundling rules, it is likely that unbundling rules will be the subject of continued litigation. There can be no assurance that our businesses will not be materially adversely affected by continued legal challenges to unbundling rules, new legislation passed in response to unbundling rules or any court decisions that result from continued legal challenge to unbundling rules or current law and regulations.

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The FCC has an open docket proposing to reform intercarrier compensation. An industry group known as the Intercarrier Compensation Forum provided a recommended framework for reforming intercarrier compensation related to switched access and reciprocal compensation charges. Other coalitions provided competing recommendations for reforming intercarrier compensation to the FCC. The FCC is evaluating all proposals and has solicited further comments on the issue.

A final decision is expected no earlier than the first quarter of 2006, and the current framework of intercarrier compensation rules could be materially affected.

On September 10, 2003, the FCC issued a Notice of Proposed Rulemaking ( NPRM ) on Total Element Long Run Incremental Cost ( TELRIC ). This is a proceeding to review the TELRIC methodology used to determine the prices charged to competitive carriers for unbundled network elements. A change in pricing methodology that materially increases unbundled network element prices would increase our costs and could adversely affect our ability to compete. A decision is anticipated during 2006.

On October 18, 2004, the FCC released an Order that extends unbundling relief to the RBOCs for mass market fiber-to-the-curb loops with fiber that is within 500 feet of the premises. The FCC also clarified that incumbent LECs are not required to add TDM capabilities into new packetized transmission facilities. It is likely that this additional unbundling relief and new network modification rule will be the subject of litigation. Such changes could limit our access to mass market customers and adversely affect our ability to compete.

On October 22, 2004, the FCC voted to eliminate any independent unbundling obligation under Section 271 of the 1996 Act for any network element that has been removed from Section 251 of the 1996 Act. Such relief could limit our access to customers and adversely affect our ability to compete.

On June 27, 2005, the United States Supreme Court recently affirmed in *National Cable and Telecom Association v. Brand X Internet Services* the FCC's 2002 ruling that cable modem service, unlike DSL service, is a non-regulated Title I information service. Consequently, cable companies do not have to unbundle their cable network or incur any resale obligations of their broadband service. The RBOCs are requesting that the FCC extend similar regulatory treatment to retail DSL service in order to maintain a level playing field with cable modem service. If the FCC broadly rules that RBOC broadband services provided over RBOC wireline facilities are information services rather than telecommunications services, then RBOCs could argue that they do not have an obligation to provide CLECs access to unbundled loops to provide broadband services. If the FCC were to accept such RBOC arguments, the resulting changes could limit our access to UNE loops to offer broadband services and affect our ability to compete.

The FCC issued on March 10, 2004 its NPRM on IP-enabled communications, which includes VoIP. The NPRM asks broad questions regarding the regulatory classifications of various IP-enabled services, including different VoIP services; the access charge and other intercarrier compensation implications; the universal service implications; and the other social policy implications such as law enforcement, disability and emergency 911 service issues and suggests, as a general proposition, the economic regulation of various IP-enabled services should be kept to a minimum.

In April 2001, the FCC released an Order in which it established a benchmark rate at which CLECs' interstate access charges would be presumed reasonable and which a CLEC could impose on an interexchange carrier ( IXC ) by tariff. In May of 2004, the FCC announced a new rule governing CLEC interstate access charges that imposed a limit on CLEC access charges when the CLEC did not directly serve the end user. The new rule provided that the charge could be no more than the rate charged by the ILEC for the same functionality. The FCC order stated its new rule limiting CLEC interstate access charges was to be applied on a prospective basis. McLeodUSA filed tariff changes to implement the FCC's new rule. The FCC's Order also provided that under its prior rules, it would not have been unreasonable for a CLEC to charge an IXC for those services at the higher benchmark rate. Some IXCs have disputed and withheld payment of billed access charges for wireless originated toll free calls and have also withheld payments due to the Company for other charges. The Company, in response to these actions, has also withheld payments from them. As of March 3, 2005, the amounts charged by the Company but not paid by these IXCs are: MCI, approximately \$6.4 million; Sprint, approximately \$4.7 million.; and Qwest, approximately \$4.9 million. The Company's withholdings, all of which are less than the amounts withheld by the IXCs are: MCI, approximately \$3.4 million; Qwest, approximately \$3.8 million; and Sprint, approximately \$0.8 million. In total, approximately \$23.5 million of access charges were disputed by these three IXCs related to certain types of toll free traffic for

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prior periods based on alleged insufficiency of tariff grounds. McLeodUSA has written contracts with two of the IXCs that identify the rates or source of rates that McLeodUSA is entitled to charge for interstate access services. McLeodUSA continued to bill for its services at the full benchmark rate until the FCC's new rule went into effect as of June 22, 2004 at which time it billed at the revised rates in accordance with by the FCC's new rule. As a consequence of the withholding of payments by these carriers, McLeodUSA filed suit against Sprint Communications Corporation ( Sprint ) in the United States District Court for the Northern District of Iowa claiming that, by Sprint's failure to pay the interstate access charges that the Company billed, Sprint was in breach of its contract with the Company. In addition to its breach of express contract claim against Sprint, the Company is pursuing recovery of its interstate access charges for toll free traffic

under implied contract and unjust enrichment theories. McLeodUSA filed suit against Qwest Corporation in this same court; however, the dispute with Qwest has been resolved and the lawsuits filed in this matter have been dismissed. The results of the resolution of this dispute are reflected in these consolidated financial statements. On December 15, 2004, the FCC issued an order in *US Telepacific* reaffirming that its rule limiting CLEC access rates to be no more than the rate charged by the ILEC for the same functionality, adopted in May 2004, was to be applied on a prospective basis only, and that it was not unreasonable for a CLEC to charge the full benchmark rate for traffic to or from end-users of other carriers, provided that the carrier serving the end-user did not also charge the IXC and provided that the CLEC's charges were otherwise in compliance with and supported by its tariff. The Company expects to resolve the dispute with MCI by the end of the year. The Company believes that recovery of withheld amounts by Sprint and MCI is probable; accordingly, no amounts have been reserved by the Company at June 30, 2005. However, certain of the underlying issues have never been litigated and are largely questions of first impression.

McLeodUSA is one of several defendants in a lawsuit brought by SBC and its affiliates in the U.S. District Court in the Eastern District of Missouri. SBC alleges that McLeodUSA conspired with one or more of Global Crossing and its affiliates, certain named competitive local exchange carriers, and/or certain unnamed least cost routers to breach SBC's state or federal tariffs, unjustly enrich themselves, and commit fraud on SBC. SBC alleges that the defendants knowingly disguised long distance calls that were terminated to SBC so that they appeared to SBC to be local calls thereby depriving SBC of the difference between the access charge rate owed for termination of long distance calls and the reciprocal compensation rate owed for termination of local calls. McLeodUSA's answer was filed on April 1, 2005, denying all liability. McLeodUSA intends to vigorously defend against these claims.

Generally, state utility commissions or third parties could raise issues with regard to our compliance with applicable laws or regulations that could have a material adverse effect on our business, results of operations and financial condition. On July 18, 2005, the Arizona Corporation Commission approved a settlement agreement between McLeodUSA and the Arizona Staff that resolved all issues related to certain agreements that we entered into with Qwest several years ago that have since expired. The Colorado Public Utilities Commission continues to review these agreements, and that proceeding may result in fines or other sanctions against us or the imposition of other conditions detrimental to us, including the establishment of discounts available to other competitive telephone companies but not to us. Other states may initiate similar proceedings.

McLeodUSA, as successor to Caprock Communications Corporation, is a defendant in a lawsuit brought by Alcatel USA Marketing, Inc. (Alcatel), in County Court No. 5, Dallas County, Texas, entitled Alcatel USA Marketing, Inc vs. Caprock Communications Corporation and McLeodUSA Holdings, Inc., Cause No. CC04-11573-E. Plaintiff alleges breach of a 1994 supply agreement and certain purchase orders issued in 2000 under the agreement. Alcatel seeks damages of approximately \$6.3 million plus interest, costs and attorneys' fees. The parties have agreed in principle to settle this dispute, the results of which are reflected in these consolidated financial statements.

On May 9, 2005, AT&T sent a demand to the Company for arbitration of its claim in excess of \$8 million under an Engineering and Construction Management Agreement between AT&T and CapRock Telecommunications Corp. dated November 1999. The claim principally relates to construction and fiber optic cable costs incurred in connection with construction of the Ring 3 fiber optic cable project from Tulsa, OK to Oklahoma City, OK from 1999 to 2000. The parties have reached an agreement in principle to settle this dispute and the parties anticipate entering into a formal settlement agreement shortly. The results of the settlement agreement are reflected in these consolidated financial statements.

As a result of the various settlements discussed above, the Company has recorded an additional charge to its operating expenses of \$3.3 million during the second quarter of 2005. McLeodUSA is not aware of any other material litigation against it. McLeodUSA does, however, have various other legal proceedings pending against it or its subsidiaries or on its behalf or that of its subsidiaries





**Information Regarding Forward-Looking Statements**



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Some of the statements in this discussion include statements about our future expectations. Statements that are not historical facts are forward-looking statements for the purpose of the safe harbor provided by Section 21E of the Exchange Act and Section 27A of the Securities Act. Such statements may include projections of financial and operational results and goals, including revenue, profitability, savings and cash. In some cases, you can identify these so-called forward looking statements by our use of words such as may, will, should, expect, plan, anticipate, believe, estimate, predict, project, intend or potential or the negative of those words and other comparable words. These forward-looking statements are subject to known as well as unknown risks and uncertainties that may cause actual results to differ materially from our expectations. Our expectations are based on various factors and assumptions and reflect only our predictions. Factors that could cause actual results to differ materially from the forward-looking statement include technological, regulatory, public policy or other developments in our industry, availability and adequacy of capital resources, our ability to continue as a going concern, our ability to implement a capital restructuring, current and future economic conditions, the existence of strategic alliances, our ability to generate cash, our ability to implement process and network improvements, our ability to attract and retain customers, our ability to migrate traffic to appropriate platforms and changes in the competitive climate in which we operate. These and other risks are described in more detail in our most recent Annual Report on Form 10-K filed with the SEC. Except as required under the federal securities laws and rules and regulations of the SEC, the Company undertakes no obligation to update publicly any forward-looking statements, whether as a result of future events, new information or otherwise.

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



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The following discussion and analysis provides information concerning the results of operations and our financial condition and should be read in conjunction with the accompanying unaudited condensed consolidated financial statements and notes thereto. Additionally, the following discussion and analysis should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2004.

### *Executive Overview*



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In the fourth quarter of 2001, we developed a revised strategic plan, which focused on profitable revenue growth in our 25-state footprint. In order to execute our plan we initiated a variety of programs across the business to significantly improve the customer experience, eliminate unneeded infrastructure and cost, improve the quality of the network and grow the top line revenues. Over the past several years we have successfully executed nearly all of these programs. The operational and certain financial results of the Company, as reported in its quarterly and annual financial releases, reflect the significant progress that has been made in the operational areas.

However, the Company's revenues have not increased as forecasted and have been declining since 2002. The decline in revenue was driven primarily by our program to eliminate non-profitable customers, turnover of customers to competitors in excess of new customers acquired, reduction in access rates as mandated by the FCC, and lower prices for some of our products. We have taken significant actions to increase revenue, including introduction of new competitively priced products, reorganization of the sales operation, expanding the involvement of the board of directors and executive staff in the sales process and reducing customer churn. To date, these actions have not resulted in profitable new revenue growth which continues to be a challenge as we compete against large, financially strong competitors with well-known brands. With the pending mergers in the industry, we believe that the large telecommunications providers will likely become even more aggressive upon the closing of these transactions further challenging our ability to grow revenue.

In light of the inability of the Company to achieve new revenue growth in excess of existing customer turnover and ultimately generate enough operating cash flow to service the existing level of debt, our Board of Directors authorized the Company to pursue strategic alternatives. Over the past several months we have been actively pursuing a strategic partner or a sale of the Company while also taking steps to maintain future liquidity, including evaluating a capital restructuring to reduce the current debt level enabling the Company to achieve positive cash flow going forward.

In light of our level of cash at December 31, 2004 and the payments required during the first quarter of 2005 under the Credit Facilities, we began discussions with our agent bank and a group of lenders acting as a steering committee for the lenders under our Credit Facilities. The Company entered a forbearance agreement on March 16, 2005 with our lenders whereby the lenders agree not to take any action as a result of non-payment by the Company of scheduled principal amortization under the Credit Facilities and interest payments under the Credit Agreement and any related events of default.

The initial forbearance agreement expired on May 23, 2005 but has since been extended until September 9, 2005. The forbearance agreement, among other things, limits our ability to sell certain assets without prior approval of the lender group and requires McLeodUSA to accrue two additional percentage points of interest on the outstanding loan balances. In accordance with the forbearance agreement, as of June 30, 2005, the Company has elected not to make \$15.6 million of scheduled principal payments and \$23.1 million of scheduled interest payments. We believe that by not making principal and interest payments on the Credit Facilities, cash on hand together with cash flows from operations is sufficient to maintain operations in the ordinary course without disruption of services.

At this time, we have concluded that there is not an acceptable strategic partner or buyer and we are proceeding to work with our lenders to complete a capital restructuring where the lenders would convert a substantial portion of their debt to equity and become the stockholders of the Company. There can be no assurance that we will be able to reach an agreement with our lenders regarding a capital restructuring or continued forbearance and covenant relief prior to the end of the forbearance period on September 9, 2005. In the event that we cannot reach an agreement with our lender group, it is likely that we will elect to forgo making future principal and interest payments to our lenders while we continue to seek an extended forbearance period or permanent capital restructuring from our lenders, or alternatively, we could be forced to seek protection from our creditors.

While the Company continues to explore with its lenders a capital restructuring, none of the alternatives presented to date have suggested that there will be any recovery for the Company's current preferred stock or common stockholders. Accordingly, the Company does not expect its holders of preferred or common stock to receive any recovery in a capital restructuring.

Our financial statements for the periods ending June 30, 2005 and December 31, 2004 are prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business, but we may not be able to continue as a going concern. The report of our independent registered public accounting firm accompanying our financial statements in our report on Form 10-K filed March 25, 2005, contains a comment stating that there is substantial doubt as to our ability to continue as a going concern. In the event our capital restructuring activities are not successful and we are required to seek protection from our creditors, additional significant adjustments to the Company's consolidated financial statements may be necessary.

## **Overview of Our Business**

We derive our revenue from our core telecommunications and related communications services. These include local and long distance services; local data services such as dial-up and dedicated Internet access services, using DSL, cable modem and dedicated T1 access; integrated access services, which link voice and data lines together on one high-speed connection; conference calling services; wireless services; bandwidth and network facilities leasing, sales and services, including access services; facilities and services dedicated for a particular customer's use; advanced communications services for larger businesses such as frame relay, private line, and ISDN; and value-added services such as virtual private networks, hosted exchange and shared web hosting.

As of June 30, 2005, we operated a network with 698 access nodes collocated in RBOC central offices. We serve our customers by using various loop/access unbundled network elements ( UNEs ) provided by the RBOCs and aggregating them through our access nodes. In turn, our access nodes are interconnected through approximately 38 service node locations where our switching/routing systems reside. In a metropolitan area, access node to service node connectivity is based either on our own fiber facilities or on UNE transport from the RBOCs. Our service nodes are located in most of the major metropolitan areas across our footprint. These service nodes are in turn interconnected by our high capacity, inter-city core network. The underlying transport for our core network is based either on our own fiber or on leased capacity from interexchange carriers.



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To develop these networks, we have assembled a collection of metro and inter-city network assets in our 25-state footprint, substantially all of which we own or control, making us a facilities-based carrier. These network assets incorporate state-of-the-art fiber optic cable, dedicated wavelengths of transmission capacity on fiber optic networks and transmission equipment capable of carrying high volumes of data, voice, video and Internet traffic. We operate in a 25-state footprint, which consists of the following states:

|          |           |            |              |            |
|----------|-----------|------------|--------------|------------|
| Arizona  | Indiana   | Minnesota  | North Dakota | Texas      |
| Arkansas | Iowa      | Missouri   | Ohio         | Utah       |
| Colorado | Kansas    | Montana    | Oklahoma     | Washington |
| Idaho    | Louisiana | Nebraska   | Oregon       | Wisconsin  |
| Illinois | Michigan  | New Mexico | South Dakota | Wyoming    |

**Critical Accounting Policies and Estimates**



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Preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Management believes the most complex and sensitive judgments, because of their significance to the consolidated financial statements, result primarily from the need to make estimates about the effects of matters that are inherently uncertain. Management's Discussion and Analysis and Note 1 to the Consolidated Financial Statements in the McLeodUSA Annual Report on Form 10-K for the year ended December 31, 2004, describe the significant accounting estimates and policies used in preparation of the Condensed Consolidated Financial Statements. Actual results in these areas could differ from management's estimates. There have been no significant changes in our critical accounting estimates during the six months ended June 30, 2005. Management will continue to monitor its estimates and assumptions as well as events or changes in circumstances with respect to the reported amounts of assets, liabilities, revenues and expenses while we continue our pursuit of strategic alternatives and financial restructuring.

### **Liquidity and Capital Resources**

Prior to August 2001, McLeodUSA grew rapidly by focusing on top-line revenue growth, which required significant capital for the construction of local and long distance voice networks and a national data network and included the acquisition of numerous businesses. By mid-2001, due to certain factors, including but not limited to complications related to our rapid growth and a general downturn in the economy and the telecommunications sector in particular, we were not meeting internal expectations in terms of profitability and cash flow.

Beginning in August of 2001, we initiated a new strategic plan that included a broad financial and operational restructuring. Our new strategy was to refocus our business to be a facilities-based communication services provider within our 25-state footprint, improve business discipline and processes and reduce our cost structure, all with the goal of profitably growing revenues and generating positive cash flow from operations. Key elements of the restructuring included abandonment of the national network plan, disposing of non-core businesses, reducing the employee base, consolidating facilities, reducing capital expenditures, and eliminating unprofitable services and unprofitable customers.

We initiated a variety of programs across the business to significantly improve the customer experience, eliminate unneeded infrastructure and cost, improve the quality of the network and grow the top line revenues. Over the past three years we have successfully executed nearly all of these programs. The operational and certain financial results of the Company, as reported in our quarterly and annual financial releases, reflect the significant progress that has been made in the operational areas.

As an independent communications services provider, realizing the revenue growth benefits of operational excellence continues to be a challenge for the Company as we compete against large, financially strong competitors with well-known brands. Most recently, the FCC has finalized its unbundling rules and the communications industry consolidation has accelerated. With the recent merger announcements in the industry, we believe that the large telecommunications providers will likely become even more aggressive upon the closing of these transactions further challenging our ability to grow revenue.

As discussed in the Executive Overview, we began exploring a capital restructuring with our lenders while also attempting to identify a potential strategic partner or buyer. At this time, we have concluded that there is not an acceptable strategic partner or buyer and we are proceeding to work with our lenders to complete a capital restructuring where our lenders would convert a substantial portion of their debt to equity and become the stockholders of the Company.

The Company and its lenders have agreed to extend the forbearance agreement with respect to scheduled principal and interest payments on its loans whereby the lenders agree not to take any action as a result of non-payment by the Company of scheduled principal amortization and interest payments under the Credit Agreement and any related events of default



through September 9, 2005. We believe that by not making principal and interest payments on the Credit Facilities, cash on hand together with cash flows from operations is sufficient to maintain operations in the ordinary course without disruption of services.

**2005 Cash Flow**



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We ended June 30, 2005 with \$33.4 million of cash and cash equivalents versus \$50.0 million at December 31, 2004. This decrease of \$16.6 million resulted primarily from the following:

|   |    |        |
|---|----|--------|
| Operating Activities:   |    |        |
| Decrease in cash from operations, excluding changes in assets and liabilities | \$ | (5.2)  |
| Payments for restructuring charges and liabilities                            |    | (12.0) |
| Cash provided by changes in assets and liabilities                            |    | 21.9   |
| Net cash provided by operating activities                                     |    | 4.7    |
| Investing Activities:   |    |        |
| Capital expenditures  |    | (21.0) |
| Deferred line installation costs  |    | (13.7) |
| Sale of assets  |    | 13.4   |
| Net cash used in investing activities   |    | (21.3) |
| Net decrease in cash and cash equivalents                                     | \$ | (16.6) |

The payments for restructuring charges and liabilities relate to lease payments and lease buyouts associated with facility exits and costs in connection with our pursuit of strategic alternatives and financial restructuring. We expect our cash requirements to pay remaining lease payments and lease buyouts associated with facility exits to be less than \$5 million during the remainder of 2005.

We have reduced our growth-related capital expenditure plan and expect to spend less than \$45 million during 2005. The capital expenditure plan for the rest of 2005 remains focused on supporting new product introductions and maintaining the existing business base. Deferred line installation costs are the result of costs required to add customers onto our network. Our deferred line installation expenditures throughout the rest of 2005 will be dependent on the rate at which we add new customers.

As discussed above, the Company has entered a forbearance agreement with its lenders with respect to scheduled principal and interest payments on its loans which extends through September 9, 2005. In accordance with the forbearance agreement, as of June 30, 2005, the Company has elected not to make \$15.6 million of scheduled principal payments and \$23.1 million of scheduled interest payments.

### Outlook for 2005 and Future Funding Needs





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We ended June 30, 2005 with \$33.4 million of cash on hand. From an ongoing operating standpoint, our cash requirements for the remainder of 2005 will consist of supporting new products, important capital expenditure projects, remaining lease payments and lease buyouts associated with facility exits and changes in working capital. A combination of cash on hand, cash generated from operating activities and the proceeds from the sale of certain assets will be used to meet these ongoing cash requirements. The Company is currently working with its lenders to complete a capital restructuring. While the specific terms of the restructuring have not yet been determined, it is anticipated that the expenses associated with the capital restructuring and any related business restructuring would be funded by either the existing lenders or other external sources in combination with existing cash on hand and the proceeds from any additional asset sales.

In the interim, we have continued to take additional steps to conserve cash and improve liquidity. Actions that have been taken to generate further operational efficiencies and focused expense management resulted in a 22% reduction in SG&A expenses compared to the second quarter of 2004. We have reduced our growth related capital expenditure plan and now expect to spend approximately \$45 million in 2005. As a result of the actions described above we have significantly reduced our cash usage

and expect to realize continuing benefits from these programs in 2005. We will continue to execute our cash management program while pursuing the capital restructuring discussions mentioned above.

There can be no assurance that we will be able to reach an agreement with our lenders regarding a capital restructuring or continued forbearance and covenant relief prior to the end of the forbearance period. In the event that we cannot reach an agreement with our lender group, it is likely that we will elect to forgo making future principal and interest payments to our lenders while we continue to seek an extended forbearance period or permanent capital restructuring from our lenders, or alternatively, the Company could be forced to seek protection from its creditors.

### Three Months Ended March 31, 2005 Compared with Three Months Ended March 31, 2004

**Revenue.** Total revenue for the quarter ended June 30, 2005 declined \$32.2 million, or 17%, to \$159.7 million from \$191.9 million for the quarter ended June 30, 2004. The following table compares our revenue for the three months ended June 30:

|   | 2005 |       | 2004 |       | Variance |
|---|------|-------|------|-------|----------|
| Local   | \$   | 80.5  | \$   | 93.0  | \$(12.5) |
| Long distance   |      | 33.2  |      | 33.1  | 0.1      |
| Data services and other   |      | 29.3  |      | 33.8  | \$(4.5)  |
| Carrier access  |      | 14.0  |      | 30.2  | \$(16.2) |
| Indefeasible rights of use agreements including those that qualify as sales type leases |      | 2.7   |      | 1.8   | 0.9      |
|   | \$   | 159.7 | \$   | 191.9 | \$(32.2) |

Total revenues declined by \$32.2 million versus the second quarter of 2004 primarily due to a continued decline in total customers, the FCC mandated reduction in access rates and lower long distance rates. Approximately \$10.9 million of the decrease in local revenue is attributed to a reduction in the number of access lines in service due to customer turnover in excess of new lines sold. Retail long distance declined by \$6.0 million as a result of both a reduction in volume of minutes and rates of approximately \$3.1 million and \$2.9 million, respectively. This decline was offset by a \$6.1 million increase in wholesale long distance due to substantial volume increases related to several wholesale contracts. Access revenues have decreased \$16.2 million from the second quarter of 2004 due to the final phase of the FCC mandated rate reduction as well as approximately \$6 million of favorable rate settlements recorded in the second quarter of 2004 related to prior period billings. Included in revenues from indefeasible rights of use in the above table is \$1.3 million and \$1.5 million for the quarters ended June 30, 2005 and 2004, respectively, related to on-going revenues from operating leases.

**Cost of Service.** Cost of service includes expenses directly associated with providing communication services to our customers. Costs classified as cost of service include, among other items, the cost of connecting customers to our network via leased facilities, the costs paid to third party providers for interconnect access and transport services, the costs of leasing components of our network facilities and the cost of fiber related to sales and leases of network facilities. Cost of service was \$92.2 million for the quarter ended June 30, 2005, a decrease of \$13.1 million or 12% from the quarter ended June 30, 2004. Approximately \$5.9 million of the decrease reflects network cost reductions, including least cost routing, network optimization including grooms and migration of customers to the McLeodUSA network. The balance of the decrease is attributed to the reduction in revenues. The cost of fiber related to sales and leases of network facilities was \$0.3 million and less than \$0.1 million for the quarters ended June 30, 2005 and 2004,

respectively.

*Selling, general and administrative expenses.* SG&A includes expenses related to sales and marketing, customer service, internal network operations and engineering, information systems and other administrative functions. SG&A expenses were \$53.7 million for the second quarter of 2005, a decrease of \$14.8 million or 22% from 2004. The decrease in SG&A year over year is primarily attributable to actions to reduce expenses and manage cash including a planned reduction in headcount. Headcount decreased from approximately 2,500 at June 30, 2004 to 2,100 employees at June 30, 2005.

*Depreciation and amortization.* Depreciation and amortization includes the depreciation of our communications network and equipment, amortization of other intangibles determined to have finite lives, and amortization over the life of the customer contract of one-time direct installation costs associated with transferring customers' local line service from the RBOCs to our local telecommunications services. Depreciation and amortization expenses were \$54.5 million for the

quarter ended June 30, 2005, a decrease of \$33.9 million, from the quarter ended June 30, 2004. This decline is driven by lower depreciation expense as certain assets reached fully depreciated status in April 2005.

**Impairment charges.** In accordance with SFAS 144 and SFAS 142, we performed impairment tests on our long-lived assets and indefinite-lived intangible asset. The tests resulted in a \$202.5 million non-cash impairment charge to reduce the carrying value of our property and equipment and the McLeodUSA trade name by \$174.8 million and \$27.7 million, respectively.

**Restructuring charges.** In the second quarter of 2005, we incurred \$4.8 million in restructuring charges related to financial and legal advisors supporting our pursuit of strategic alternatives and financial restructuring.

**Interest expense.** Gross interest expense was \$19.7 million for the quarter ended June 30, 2005, an increase of \$7.7 million over the second quarter of 2004 primarily due to an increase in the average interest rates during the period. Market rates have increased, and, as a result of the event of default that occurred in March, we are required to accrue two additional percentage points of interest on our outstanding debt balance. Net interest expense increased by \$7.9 million in the quarter ended June 30, 2005 due to higher interest rates on our outstanding debt and lower capitalized interest. Interest expense of approximately \$0.2 million and \$0.4 million was capitalized as part of our construction of our network during the quarter ended June 30, 2005 and 2004, respectively.

The Company's operating results during the quarter ended June 30, 2005, include an unfavorable impact of approximately \$4.0 million related to the resolution of various legal & commercial disputes.

#### Six Months Ended June 30, 2005 Compared with Six Months Ended June 30, 2004

**Revenue.** Total revenue for the six months ended June 30, 2005 declined \$65.3 million, or 17%, to \$320.2 million from \$385.5 million for the six months ended June 30, 2004. The following table compares our revenue for the six months ended June 30:

|   | 2005     | 2004     | Variance  |
|---|----------|----------|-----------|
| Local   | \$ 163.9 | \$ 188.5 | \$ (24.6) |
| Long distance   | 66.7     | 69.0     | (2.3)     |
| Data services and other   | 58.3     | 69.3     | (11.0)    |
| Carrier access  | 26.5     | 55.0     | (28.5)    |
| Indefeasible rights of use agreements including those that qualify as sales type leases | 4.8      | 3.7      | 1.1       |
|   | \$ 320.2 | \$ 385.5 | \$ (65.3) |

Total revenues declined by \$65.3 million versus the first six months of 2005 due to a continued decline in total customers, the FCC mandated reduction in access rates, and lower long distance rates. Approximately \$23.8 million of the decrease in local revenue is attributed to a reduction in the number of access lines in service due to customer turnover in excess of new lines sold. Retail long distance declined by \$14.5 million as a result of both a reduction in volume and rates of approximately \$8.8 million and \$5.7 million, respectively. This decline was partially offset by a \$12.3 million increase in wholesale long distance due to substantial volume increases related to several wholesale contracts. Access revenues have decreased \$28.5 million from the second quarter of 2004 due to the final phase of the FCC mandated rate reduction as well as approximately \$6 million of favorable rate settlements recorded in 2004 related to prior period billings. Included in revenues from indefeasible rights of use in the above table is \$2.7 million and \$2.9 million for the six month periods ended June 30, 2005 and 2004, respectively, related to on-going revenues from operating leases.

*Cost of Service.* Cost of service includes expenses directly associated with providing communication services to our customers. Costs classified as cost of service include, among other items, the cost of connecting customers to our network via leased facilities, the costs paid to third party providers for interconnect access and transport services, the costs of leasing components of our network facilities and the cost of fiber related to sales and leases of network facilities. Cost of service was \$185.5 million for the six month period ended June 30, 2005, a decrease of \$27.4 million or 13% from the six month period ended June 30, 2004. Approximately \$13.0 million of the decrease reflects network cost reductions, including least cost routing, network optimization including grooms and migration of customers to the McLeodUSA network. The balance of the decrease is attributed to the reduction in revenues. The cost of fiber related to sales and leases of network facilities was \$0.4 million for the six months ended June 30, 2005 and \$0.1 million for the six months ended June 30, 2004.

**Selling, general and administrative expenses.** SG&A includes expenses related to sales and marketing, customer service, internal network operations and engineering, information systems and other administrative functions. SG&A expenses were \$110.4 million for the six months of 2005, a decrease of \$33.8 million or 23% from 2004. The decrease in SG&A year over year is primarily attributable to actions to reduce expenses and manage cash as well as reduced headcount. Headcount decreased from approximately 2,500 at June 30, 2004 to 2,100 employees at June 30, 2005.

**Depreciation and amortization.** Depreciation and amortization includes the depreciation of our communications network and equipment, amortization of other intangibles determined to have finite lives, and amortization over the life of the customer contract of one-time direct installation costs associated with transferring customers' local line service from the RBOCs to our local telecommunications services. Depreciation and amortization expenses were \$145.8 million for the six months ended June 30, 2005, decrease of \$32.8 million over the second quarter of 2004. This decline is driven by lower depreciation expense as certain assets reached fully depreciated status in April 2005.

**Impairment charges.** In accordance with SFAS 144 and SFAS 142, we performed impairment tests on our long-lived assets and indefinite-lived intangible asset. The tests resulted in a \$202.5 million non-cash impairment charge to reduce the carrying value of our property and equipment and the McLeodUSA trade name by \$174.8 million and \$27.7 million, respectively.

**Restructuring charges.** In the six months ended June 30, 2005, we incurred \$6.9 million in restructuring charges related to financial and legal advisors supporting our pursuit of strategic alternatives and financial restructuring.

**Interest expense.** Gross interest expense was \$34.3 million for the six months ended June 30, 2005, an increase of \$10.4 million over the six months ended June 30, 2004 primarily due to an increase in the average interest rates during the period. Market rates have increased, and, as a result of the event of default that occurred in March, we are required to accrue two additional percentage points of interest on our outstanding debt balance. Net interest expense increased by \$11.1 million in the six months ended June 30, 2005 due to higher interest rates on our outstanding debt. Interest expense of approximately \$0.4 million and \$1.1 million was capitalized as part of our construction of our network during the six months ended June 30, 2005 and 2004, respectively.

The Company's operating results for the six months ended June 30, 2005, include an unfavorable impact of approximately \$4.0 million related to the resolution of various legal and commercial disputes.

#### **Inflation**





We do not believe that inflation has had a significant impact on our consolidated operations.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**



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We have variable rate debt of approximately \$777 million under the Credit Agreement outstanding at June 30, 2005. If market interest rates average 1% more in subsequent quarters than the rates during the quarter ended June 30, 2005, quarterly interest expense would increase by \$1.9 million. This amount was determined by calculating the effect of the hypothetical interest rate increase on our variable rate debt for the quarter and does not assume changes in our financial structure.

### **Item 4. Controls and Procedures**



*Disclosure Controls and Procedures.* The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were effective.

*Internal Controls over Financial Reporting.* There have not been any changes in the Company's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II**  
**OTHER INFORMATION**

**Item 1. Legal Proceedings**

Former Chairman Clark E. McLeod, former President Stephen C. Gray (then also Chief Executive Officer), Chairman and Chief Executive Officer Chris A. Davis (then Chief Operating and Financial Officer) and former Chief Financial and Accounting Officer J. Lyle Patrick (the Individual Defendants ) are defendants in a consolidated class action entitled *In re McLeodUSA Incorporated Securities Litigation*, Civil Action No. C02-0001 (N.D. Iowa) (the Iowa Class Action ), alleging inter alia, violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Individual Defendants moved to dismiss the consolidated amended complaint in the Iowa Class Action. That motion was denied. Discovery is ongoing. One of the putative class plaintiffs, New Millennium Growth Fund LLC, also filed proofs of claim against McLeodUSA in McLeodUSA's Chapter 11 Case, seeking at least \$104,650 on its own behalf and no less than approximately \$300 million (plus interest, costs and attorneys' fees as allowed) on behalf of all class claimants in the Iowa Class Action (the Bankruptcy Claims ) and, together with the Iowa Class Action, the Securities Claims ). The Bankruptcy Claims were transferred from the bankruptcy court in Delaware to the Iowa court, and consolidated with the Iowa Class Action on February 1, 2005. As the Securities Claims are in early stages, it is impossible to evaluate the likelihood of unfavorable outcomes or, with respect to McLeodUSA's indemnification obligations in connection with the claims alleged against the Individual Defendants in the consolidated amended complaint, estimate the amount or range of potential loss, if any, to McLeodUSA. With respect to the Bankruptcy Claims, on May 2, 2002, the Bankruptcy Court issued an order establishing a disputed claims reserve of 18,000,000 shares of Reorganized McLeodUSA Class A Common Stock. Any recovery from the Bankruptcy Claims would be limited to those shares of stock. McLeodUSA believes that the Securities Claims are without merit and intends to defend them vigorously.

McLeodUSA has indemnification obligations running to the Individual Defendants, the terms of which provide for no limitation to the maximum potential future payments under such indemnifications. McLeodUSA is unable to develop an estimate of the maximum potential amount of future payments under the indemnifications due to the inherent uncertainties involved in such litigation. McLeodUSA maintains insurance, subject to limitations set forth in the policies, which is intended to cover the costs of claims made against its current and former Directors and Officers, including the Individual Defendants.

McLeodUSA is also involved in numerous regulatory proceedings before various public utility commissions and the FCC, particularly in connection with actions by the Regional Bell Operating Companies ( RBOCs ). McLeodUSA anticipates the RBOCs will continue to pursue litigation, regulations and legislation in states within McLeodUSA's 25-state footprint and with the FCC to reduce regulatory oversight and regulation over rates, network access and operations. The RBOCs are also actively pursuing major changes in the Telecommunications Act of 1996 ( 1996 Act ), by regulatory litigation and legislation, which McLeodUSA believes would adversely affect competitive telecommunications service providers including McLeodUSA. If adopted, these changes could make it more difficult for McLeodUSA to challenge the RBOCs actions, or to compete with the RBOCs, in the future. There are no assurances that McLeodUSA will prevail in its disputes with the RBOCs.

The FCC released its Triennial Review Order ( TRO ) in August 2003 modifying its rules governing availability of RBOC unbundled network elements to competitive carriers. The Triennial Review Order established new rules governing the availability and pricing for the network elements the RBOCs must provide to competitive carriers, and delegated authority to the states to apply certain of the new rules in individual markets. Several appeals of the TRO were consolidated in the Court of Appeals for the District of Columbia (the Court of Appeals ). On March 2, 2004, the Court of Appeals issued a decision overturning many key elements of the TRO, remanding most of the order to the FCC for further action ( *USTA II* ). The Court of Appeals ruled that the FCC's delegation of final impairment decisions to state agencies was unlawful. The Court also reversed the FCC's nationwide finding regarding mass market switching, dedicated transport and its delegation of decision-making authority to the states. The Court directed the FCC to give stronger consideration to intermodal competition when revising its rules on remand. The Court upheld the FCC determination that RBOCs do not have to provide unbundled access at current prices to newly deployed technologies based on fiber and packet-switching capabilities. The Court also upheld the FCC's findings that RBOCs are not required to provide unbundled switching to CLECs for business customers served by high-capacity loops, such as DS-1 or packet switching. State proceedings that had been started to

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implement the TRO were suspended in some states and continued in other states. The FCC and U. S. Department of Justice declined to appeal *USTA II*. Competitive and interexchange carriers and an organization representing state regulatory



agencies filed appeals to the U.S. Supreme Court and requested a stay. The U.S. Supreme Court declined to issue a stay. On July 22, the FCC adopted and on August 22, 2004, the FCC released an Interim UNE Order (the Interim Order ) establishing requirements that govern the availability of UNEs until the FCC adopts new, permanent unbundling rules. On December 15, 2004, the FCC announced adoption of revised permanent unbundling rules that it believes are in compliance with prior appellate decisions. These new unbundling rules impact access to local switching, high capacity loops, high capacity transport, dark fiber, and entrance facilities. The FCC also adopted a transition plan for those elements that will no longer be UNEs. The Company believes that the new rules are predominantly supportive of its facilities-based (UNE-L) strategy. The new unbundling rules became effective March 11, 2005.

Regardless of the success, or lack of success, of commercial negotiations with Qwest and SBC and adoption of final unbundling rules, it is likely that unbundling rules will be the subject of continued litigation. There can be no assurance that our businesses will not be materially adversely affected by continued legal challenges to unbundling rules, new legislation passed in response to unbundling rules or any court decisions that result from continued legal challenge to unbundling rules or current law and regulations.

The FCC has an open docket proposing to reform intercarrier compensation. An industry group known as the Intercarrier Compensation Forum provided a recommended framework for reforming intercarrier compensation related to switched access and reciprocal compensation charges. Other coalitions provided competing recommendations for reforming intercarrier compensation to the FCC. The FCC is evaluating all proposals and has solicited further comments on the issue. A final decision is expected no earlier than the first quarter of 2006, and the current framework of intercarrier compensation rules could be materially affected.

On September 10, 2003, the FCC issued a Notice of Proposed Rulemaking ( NPRM ) on Total Element Long Run Incremental Cost ( TELRIC ). This is a proceeding to review the TELRIC methodology used to determine the prices charged to competitive carriers for unbundled network elements. A change in pricing methodology that materially increases unbundled network element prices would increase our costs and could adversely affect our ability to compete. A decision is anticipated during 2006.

On October 18, 2004, the FCC released an Order that extends unbundling relief to the RBOCs for mass market fiber-to-the-curb loops with fiber that is within 500 feet of the premises. The FCC also clarified that incumbent LECs are not required to add TDM capabilities into new packetized transmission facilities. It is likely that this additional unbundling relief and new network modification rule will be the subject of litigation. Such changes could limit our access to mass market customers and adversely affect our ability to compete.

On October 22, 2004, the FCC voted to eliminate any independent unbundling obligation under Section 271 of the 1996 Act for any network element that has been removed from Section 251 of the 1996 Act. Such relief could limit our access to customers and adversely affect our ability to compete.

On June 27, 2005, the United States Supreme Court recently affirmed in *National Cable and Telecom Association v. Brand X Internet Services* the FCC's 2002 ruling that cable modem service, unlike DSL service, is a non-regulated Title I information service. Consequently, cable companies do not have to unbundle their cable network or incur any resale obligations of their broadband service. The RBOCs are requesting that the FCC extend similar regulatory treatment to retail DSL service in order to maintain a level playing field with cable modem service. If the FCC broadly rules that RBOC broadband services provided over RBOC wireline facilities are information services rather than telecommunications services, then RBOCs could argue that they do not have an obligation to provide CLECs access to unbundled loops to provide broadband services. If the FCC were to accept such RBOC arguments, the resulting changes could limit our access to UNE loops to offer broadband services and affect our ability to compete.

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The FCC issued on March 10, 2004 its NPRM on IP-enabled communications, which includes VoIP. The NPRM asks broad questions regarding the regulatory classifications of various IP-enabled services, including different VoIP services; the access charge and other intercarrier compensation implications; the universal service implications; and the other social policy implications such as law enforcement, disability and emergency 911 service issues and suggests, as a general proposition, the economic regulation of various IP-enabled services should be kept to a minimum.

In April 2001, the FCC released an Order in which it established a benchmark rate at which CLECs interstate access charges would be presumed reasonable and which a CLEC could impose on an interexchange carrier ( IXC ) by tariff. In May of 2004, the FCC announced a new rule governing CLEC interstate access charges that imposed a limit on CLEC

access charges when the CLEC did not directly serve the end user. The new rule provided that the charge could be no more than the rate charged by the ILEC for the same functionality. The FCC order stated its new rule limiting CLEC interstate access charges was to be applied on a prospective basis. McLeodUSA filed tariff changes to implement the FCC's new rule. The FCC's Order also provided that under its prior rules, it would not have been unreasonable for a CLEC to charge an IXC for those services at the higher benchmark rate. Some IXCs have disputed and withheld payment of billed access charges for wireless originated toll free calls and have also withheld payments due to the Company for other charges. The Company, in response to these actions, has also withheld payments from them. As of March 3, 2005, the amounts charged by the Company but not paid by these IXCs are: MCI, approximately \$6.4 million; Sprint, approximately \$4.7 million; and Qwest, approximately \$4.9 million. The Company's withholdings, all of which are less than the amounts withheld by the IXCs are: MCI, approximately \$3.4 million; Qwest, approximately \$3.8 million; and Sprint, approximately \$0.8 million. In total, approximately \$23.5 million of access charges were disputed by these three IXCs related to certain types of toll free traffic for prior periods based on alleged insufficiency of tariff grounds. McLeodUSA has written contracts with two of the IXCs that identify the rates or source of rates that McLeodUSA is entitled to charge for interstate access services. McLeodUSA continued to bill for its services at the full benchmark rate until the FCC's new rule went into effect as of June 22, 2004 at which time it billed at the revised rates in accordance with by the FCC's new rule. As a consequence of the withholding of payments by these carriers, McLeodUSA filed suit against Sprint Communications Corporation (Sprint) in the United States District Court for the Northern District of Iowa claiming that, by Sprint's failure to pay the interstate access charges that the Company billed, Sprint was in breach of its contract with the Company. In addition to its breach of express contract claim against Sprint, the Company is pursuing recovery of its interstate access charges for toll free traffic under implied contract and unjust enrichment theories. McLeodUSA filed suit against Qwest Corporation in this same court; however, the dispute with Qwest has been resolved and the lawsuits filed in this matter have been dismissed. The results of the resolution of this dispute are reflected in these consolidated financial statements. On December 15, 2004, the FCC issued an order in *US Telepacific* reaffirming that its rule limiting CLEC access rates to be no more than the rate charged by the ILEC for the same functionality, adopted in May 2004, was to be applied on a prospective basis only, and that it was not unreasonable for a CLEC to charge the full benchmark rate for traffic to or from end-users of other carriers, provided that the carrier serving the end-user did not also charge the IXC and provided that the CLEC's charges were otherwise in compliance with and supported by its tariff. The Company expects to resolve the dispute with MCI by the end of the year. The Company believes that recovery of withheld amounts by Sprint and MCI is probable; accordingly, no amounts have been reserved by the Company at June 30, 2005. However, certain of the underlying issues have never been litigated and are largely questions of first impression.

McLeodUSA is one of several defendants in a lawsuit brought by SBC and its affiliates in the U.S. District Court in the Eastern District of Missouri. SBC alleges that McLeodUSA conspired with one or more of Global Crossing and its affiliates, certain named competitive local exchange carriers, and/or certain unnamed least cost routers to breach SBC's state or federal tariffs, unjustly enrich themselves, and commit fraud on SBC. SBC alleges that the defendants knowingly disguised long distance calls that were terminated to SBC so that they appeared to SBC to be local calls thereby depriving SBC of the difference between the access charge rate owed for termination of long distance calls and the reciprocal compensation rate owed for termination of local calls. McLeodUSA's answer was filed on April 1, 2005, denying all liability. McLeodUSA intends to vigorously defend against these claims.

Generally, state utility commissions or third parties could raise issues with regard to our compliance with applicable laws or regulations that could have a material adverse effect on our business, results of operations and financial condition. On July 18, 2005, the Arizona Corporation Commission approved a settlement agreement between McLeodUSA and the Arizona Staff that resolved all issues related to certain agreements that we entered into with Qwest several years ago that have since expired. The Colorado Public Utilities Commission continues to review these agreements, and that proceeding may result in fines or other sanctions against us or the imposition of other conditions detrimental to us, including the establishment of discounts available to other competitive telephone companies but not to us. Other states may initiate similar proceedings.

McLeodUSA, as successor to Caprock Communications Corporation, is a defendant in a lawsuit brought by Alcatel USA Marketing, Inc. (Alcatel), in County Court No. 5, Dallas County, Texas, entitled Alcatel USA Marketing, Inc vs. Caprock Communications Corporation and McLeodUSA Holdings, Inc., Cause No. CC04-11573-E. Plaintiff alleges breach of a 1994 supply agreement and certain purchase orders issued in 2000 under the agreement. Alcatel seeks damages of approximately \$6.3 million plus interest, costs and attorneys' fees. The parties have agreed in principle to settle this dispute, the results of which are reflected in these consolidated financial statements.



On May 9, 2005, AT&T sent a demand to the Company for arbitration of its claim in excess of \$8 million under an Engineering and Construction Management Agreement between AT&T and CapRock Telecommunications Corp. dated November 1999. The claim principally relates to construction and fiber optic cable costs incurred in connection with construction of the Ring 3 fiber optic cable project from Tulsa, OK to Oklahoma City, OK from 1999 to 2000. The parties have reached an agreement in principle to settle this dispute and the parties anticipate entering into a formal settlement agreement shortly. The results of the settlement agreement are reflected in these consolidated financial statements.

As a result of the various settlements discussed above, the Company has recorded an additional charge to its operating expenses of \$3.3 million during the second quarter of 2005. McLeodUSA is not aware of any other material litigation against it. McLeodUSA does, however, have various other legal proceedings pending against it or its subsidiaries or on its behalf or that of its subsidiaries

**Item 6. Exhibits**

| <b>Exhibit Number</b> | <b>Exhibit Description</b>   |
|-----------------------|--|
| 31.1                  | Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2                  | Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1                  | Certification of CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2                  | Certification of CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**MCLEODUSA INCORPORATED**  
(registrant)

Date: August 9, 2005

By: */s/ Chris A. Davis*  
Chris A. Davis  
*Chairman and Chief Executive Officer*

Date: August 9, 2005

By: */s/ G. Kenneth Burckhardt*  
G. Kenneth Burckhardt  
*Chief Financial Officer*

**INDEX TO EXHIBITS**





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