

# AT&T Inc. Financial Review 2007



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## Selected Financial and Operating Data

Dollars in millions except per share amounts

| At December 31 or for the year ended:   | 2007             | 2006 <sup>2</sup> | 2005 <sup>3</sup> | 2004            | 2003            |
|---|------------------|-------------------|-------------------|-----------------|-----------------|
| <b>Financial Data<sup>1</sup></b>   |                  |                   |                   |                 |                 |
| Operating revenues  | \$118,928        | \$ 63,055         | \$ 43,764         | \$ 40,733       | \$ 40,498       |
| Operating expenses  | \$ 98,524        | \$ 52,767         | \$ 37,596         | \$ 34,832       | \$ 34,214       |
| Operating income  | \$ 20,404        | \$ 10,288         | \$ 6,168          | \$ 5,901        | \$ 6,284        |
| Interest expense  | \$ 3,507         | \$ 1,843          | \$ 1,456          | \$ 1,023        | \$ 1,191        |
| Equity in net income of affiliates  | \$ 692           | \$ 2,043          | \$ 609            | \$ 873          | \$ 1,253        |
| Other income (expense) – net  | \$ 615           | \$ 393            | \$ 397            | \$ 1,414        | \$ 2,370        |
| Income taxes  | \$ 6,253         | \$ 3,525          | \$ 932            | \$ 2,186        | \$ 2,857        |
| <b>Income from continuing operations</b>  | <b>\$ 11,951</b> | <b>\$ 7,356</b>   | <b>\$ 4,786</b>   | <b>\$ 4,979</b> | <b>\$ 5,859</b> |
| <b>Income from discontinued operations, net of tax<sup>4</sup></b>                  | <b>\$ —</b>      | <b>\$ —</b>       | <b>\$ —</b>       | <b>\$ 908</b>   | <b>\$ 112</b>   |
| <b>Income before extraordinary item and cumulative effect of accounting changes</b> | <b>\$ 11,951</b> | <b>\$ 7,356</b>   | <b>\$ 4,786</b>   | <b>\$ 5,887</b> | <b>\$ 5,971</b> |
| <b>Net income<sup>5</sup></b>   | <b>\$ 11,951</b> | <b>\$ 7,356</b>   | <b>\$ 4,786</b>   | <b>\$ 5,887</b> | <b>\$ 8,505</b> |
| <b>Earnings per common share:</b>   |                  |                   |                   |                 |                 |
| <b>Income from continuing operations</b>  | <b>\$ 1.95</b>   | <b>\$ 1.89</b>    | <b>\$ 1.42</b>    | <b>\$ 1.50</b>  | <b>\$ 1.77</b>  |
| <b>Income before extraordinary item and cumulative effect of accounting changes</b> | <b>\$ 1.95</b>   | <b>\$ 1.89</b>    | <b>\$ 1.42</b>    | <b>\$ 1.78</b>  | <b>\$ 1.80</b>  |
| <b>Net income<sup>5</sup></b>   | <b>\$ 1.95</b>   | <b>\$ 1.89</b>    | <b>\$ 1.42</b>    | <b>\$ 1.78</b>  | <b>\$ 2.56</b>  |
| <b>Earnings per common share – assuming dilution:</b>                               |                  |                   |                   |                 |                 |
| <b>Income from continuing operations</b>  | <b>\$ 1.94</b>   | <b>\$ 1.89</b>    | <b>\$ 1.42</b>    | <b>\$ 1.50</b>  | <b>\$ 1.76</b>  |
| <b>Income before extraordinary item and cumulative effect of accounting changes</b> | <b>\$ 1.94</b>   | <b>\$ 1.89</b>    | <b>\$ 1.42</b>    | <b>\$ 1.77</b>  | <b>\$ 1.80</b>  |
| <b>Net income<sup>5</sup></b>   | <b>\$ 1.94</b>   | <b>\$ 1.89</b>    | <b>\$ 1.42</b>    | <b>\$ 1.77</b>  | <b>\$ 2.56</b>  |
| Total assets  | \$275,644        | \$270,634         | \$145,632         | \$110,265       | \$102,016       |
| Long-term debt  | \$ 57,255        | \$ 50,063         | \$ 26,115         | \$ 21,231       | \$ 16,097       |
| Construction and capital expenditures   | \$ 17,717        | \$ 8,320          | \$ 5,576          | \$ 5,099        | \$ 5,219        |
| Dividends declared per common share <sup>6</sup>                                    | \$ 1.47          | \$ 1.35           | \$ 1.30           | \$ 1.26         | \$ 1.41         |
| Book value per common share   | \$ 19.09         | \$ 18.52          | \$ 14.11          | \$ 12.27        | \$ 11.57        |
| Ratio of earnings to fixed charges  | 4.91             | 5.01              | 4.11              | 6.32            | 6.55            |
| Debt ratio  | 35.7%            | 34.1%             | 35.9%             | 40.0%           | 32.0%           |
| Weighted-average common shares outstanding (000,000)                                | 6,127            | 3,882             | 3,368             | 3,310           | 3,318           |
| Weighted-average common shares outstanding with dilution (000,000)                  | 6,170            | 3,902             | 3,379             | 3,322           | 3,329           |
| End of period common shares outstanding (000,000)                                   | 6,044            | 6,239             | 3,877             | 3,301           | 3,305           |
| <b>Operating Data</b>   |                  |                   |                   |                 |                 |
| Wireless customers (000) <sup>7</sup>   | 70,052           | 60,962            | 54,144            | 49,132          | 24,027          |
| In-region network access lines in service (000) <sup>8</sup>                        | 61,582           | 66,469            | 49,413            | 52,356          | 54,683          |
| Broadband connections (000) <sup>9</sup>  | 14,156           | 12,170            | 6,921             | 5,104           | 3,515           |
| Number of employees   | 309,050          | 304,180           | 189,950           | 162,700         | 168,950         |

<sup>1</sup>Amounts in the above table have been prepared in accordance with U.S. generally accepted accounting principles.

<sup>2</sup>Our 2006 income statement amounts reflect results from BellSouth Corporation (BellSouth) and AT&T Mobility LLC (AT&T Mobility), formerly Cingular Wireless LLC, for the two days following the December 29, 2006 acquisition. Our 2006 balance sheet and end-of-year metrics include 100% of BellSouth and AT&T Mobility. Prior to the December 29, 2006 BellSouth acquisition, AT&T Mobility was a joint venture in which we owned 60% and was accounted for under the equity method.

<sup>3</sup>Our 2005 income statement amounts reflect results from AT&T Corp. for the 43 days following the November 18, 2005 acquisition. Our 2005 balance sheet and end-of-year metrics include 100% of AT&T Corp.

<sup>4</sup>Our financial statements reflect results from our sold directory advertising business in Illinois and northwest Indiana as discontinued operations. The operational results and the gain associated with the sale of that business are presented in "Income from discontinued operations, net of tax."

<sup>5</sup>Amounts include the following extraordinary item and cumulative effect of accounting changes: 2003, extraordinary loss of \$7 related to the adoption of FIN 46 "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" and the cumulative effect of accounting changes of \$2,541, which includes a \$3,677 benefit related to the adoption of SFAS No. 143, "Accounting for Asset Retirement Obligations" and a \$1,136 charge related to the January 1, 2003 change in the method in which we recognize revenues and expenses related to publishing directories from the "issue basis" method to the "amortization" method.

<sup>6</sup>Dividends declared per common share in 2003 included three additional dividends totaling \$0.25 per share above our regular quarterly dividend payout.

<sup>7</sup>The number presented represents 100% of AT&T Mobility cellular/PCS customers. The 2004 number includes customers from the acquisition of AT&T Wireless Services, Inc.

<sup>8</sup>In-region represents access lines serviced by our incumbent local exchange companies (in 22 states since the BellSouth acquisition and in 13 states prior to that acquisition). Beginning in 2006 the number includes BellSouth lines in service.

<sup>9</sup>Broadband connections include in-region DSL lines, in-region U-verse high-speed Internet access and satellite broadband.

## Management's Discussion and Analysis of Financial Condition and Results of Operations

Dollars in millions except per share amounts

For ease of reading, AT&T Inc. is referred to as "we," "AT&T" or the "Company" throughout this document and the names of the particular subsidiaries and affiliates providing the services generally have been omitted. AT&T is a holding company whose subsidiaries and affiliates operate in the communications services industry both in the United States and internationally providing wireless and wireline telecommunications services and equipment as well as directory advertising and publishing services. You should read this discussion in conjunction with the consolidated financial statements and accompanying notes. A reference to a "Note" in this section refers to the accompanying Notes to Consolidated Financial Statements. In the tables throughout this section, percentage increases and decreases that equal or exceed 100% are not considered meaningful and are denoted with a dash.

### RESULTS OF OPERATIONS

**Consolidated Results** Our financial results are summarized in the table below. We then discuss factors affecting our overall results for the past three years. These factors are discussed in more detail in our "Segment Results" section. We also discuss our expected revenue and expense trends for 2008 in the "Operating Environment and Trends of the Business" section.

We completed our acquisition of BellSouth Corporation (BellSouth) on December 29, 2006. We thereby acquired BellSouth's 40% economic interest in AT&T Mobility LLC (AT&T Mobility), formerly Cingular Wireless LLC (Cingular), resulting in 100% ownership of AT&T Mobility. Our consolidated results in 2006 include BellSouth's and AT&T Mobility's operational results for the final two days of the year. Prior to the acquisition, we reported the income from our 60% share of AT&T Mobility as equity in net income. We completed our acquisition of AT&T Corp. (ATTC) on November 18, 2005 and have included ATTC results during 2006 and for the 43-day period ended December 31, 2005. In accordance with U.S. generally accepted accounting principles (GAAP), operating results from BellSouth, AT&T Mobility and ATTC prior to their respective acquisition dates are excluded.

|                            | 2007      | 2006     | 2005     | Percent Change |               |
|----------------------------|-----------|----------|----------|----------------|---------------|
|                            |           |          |          | 2007 vs. 2006  | 2006 vs. 2005 |
| Operating revenues         | \$118,928 | \$63,055 | \$43,764 | 88.6%          | 44.1%         |
| Operating expenses         | 98,524    | 52,767   | 37,596   | 86.7           | 40.4          |
| Operating income           | 20,404    | 10,288   | 6,168    | 98.3           | 66.8          |
| Income before income taxes | 18,204    | 10,881   | 5,718    | 67.3           | 90.3          |
| Net income                 | 11,951    | 7,356    | 4,786    | 62.5           | 53.7          |
| Diluted earnings per share | 1.94      | 1.89     | 1.42     | 2.6            | 33.1          |

#### Overview

**Operating income** As noted above, 2007 revenues and expenses reflect the addition of BellSouth's and AT&T Mobility's results while our 2006 results only include two days of their results. Additionally, 2006 revenues and expenses reflect the addition of ATTC's results while our 2005 results include only 43 days. Accordingly, the following discussion of changes in our revenues and expenses is significantly affected by these acquisitions.

Our operating income increased \$10,116, or 98.3%, in 2007 and \$4,120, or 66.8%, in 2006. Our operating income margin increased from 14.1% in 2005 to 16.3% in 2006 and to 17.2% in 2007. Operating income in 2007 increased primarily due to the acquisition of BellSouth and increased in 2006 primarily due to the acquisition of ATTC. The increased operating margins reflect expense reductions through merger synergies, the addition of the higher-margined wireline operations at BellSouth in 2007 and operational improvements partially offset by additional amortization expense on those intangibles identified at the time of our acquisitions and by non-merger severance. As we amortize several merger-related intangible assets using the sum-of-the-months-digits method, amortization expense decreases as the amount of time we hold the asset increases.

Our operating income was slightly offset by the continued decline of our retail access lines due to increased competition, as customers continued to disconnect both primary and additional lines and switched to competitors' wireless, Voice over Internet Protocol (VoIP) and cable offerings for voice and data. While we lose the wireline voice revenues, we have the opportunity to increase wireless service revenue should customers choose AT&T Mobility as their alternative provider.

**Operating revenues** increased \$55,873, or 88.6%, in 2007 and \$19,291, or 44.1%, in 2006. These increases were primarily due to our acquisitions and to an increased demand for data products. The increases were slightly offset by continued pressure on voice revenues, reflecting access line decreases, and by decreased demand for local wholesale services.

**Operating expenses** increased \$45,757, or 86.7%, in 2007 and \$15,171, or 40.4%, in 2006, primarily due to our acquisitions. Operating expenses included merger integration costs of \$1,272 in 2007 and \$774 in 2006, and amortization expense on intangible assets identified at the time of acquisition of \$5,921 in 2007 and \$943 in 2006. We are amortizing these intangibles using the sum-of-the-months-digits method, which means that we will record higher expenses in earlier periods. Partially offsetting these increases were merger synergies of approximately \$3,000 in 2007 and \$1,000 in 2006, reflecting progress with the integration of BellSouth, AT&T Mobility and ATTC, workforce reductions and other cost-reduction initiatives.

**Interest expense** increased \$1,664, or 90.3%, in 2007 and \$387, or 26.6%, in 2006. The increase in 2007 was primarily due to higher average debt balances resulting from the inclusion of BellSouth and AT&T Mobility outstanding debt on our consolidated balance sheet. The increase in 2006 was primarily due to recording a full year of interest expense on ATTC outstanding debt.

**Equity in net income of affiliates** Investments in partnerships, joint ventures and less-than-majority-owned subsidiaries where we have significant influence are accounted for under the equity method. Prior to the December 29, 2006 BellSouth acquisition (see Note 2), we accounted for our 60% economic

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

interest in AT&T Mobility under the equity method since we shared control equally with BellSouth. AT&T Mobility is now a wholly-owned subsidiary of AT&T, and wireless results are reflected in operating revenues and expenses in our consolidated statements of income.

Equity in net income of affiliates decreased \$1,351 in 2007. The decrease in 2007 was a result of the change in accounting for AT&T Mobility to a wholly-owned subsidiary, partially offset by improved results from our investments in América Móvil S.A. de C.V. (América Móvil) and Teléfonos de México, S.A. de C.V. (Telmex). Equity in net income of affiliates increased \$1,434 in 2006. The increase in 2006 was primarily due to AT&T Mobility's improved results, of which \$1,308 was our proportionate share.

**Other income (expense) – net** We had other income of \$615 in 2007, \$393 in 2006 and \$397 in 2005. Results for 2007 included gains of \$409 related to a wireless spectrum license exchange, \$166 in interest income, \$148 from the sale of administrative buildings and other non-strategic assets and \$88 from other non-operating activities. These gains were partially offset by \$196 in minority interest expense.

Other income for 2006 included interest income of \$377. There were no individually significant other income or expense transactions during 2006. Results for 2005 primarily included interest income of \$383, a gain of \$108 on the sales of shares of Amdocs Limited, American Tower Corp. (American Tower) and Yahoo! Inc. and other miscellaneous gains. These gains were partially offset by other 2005 expenses of \$126 to reflect an increase in value of a third-party minority holder's interest in an AT&T subsidiary's preferred stock and other miscellaneous expenses.

### Supplemental Consolidated Operating Revenues Information

|                            | Actual<br>2007 | Pro Forma<br>2006 | Pro Forma<br>2005 | Percent Change   |                  |
|----------------------------|----------------|-------------------|-------------------|------------------|------------------|
|                            |                |                   |                   | 2007 vs.<br>2006 | 2006 vs.<br>2005 |
| Segment operating revenues |                |                   |                   |                  |                  |
| Voice                      | \$ 40,798      | \$ 43,505         | \$ 46,849         | (6.2)%           | (7.1)%           |
| Data                       | 23,206         | 22,173            | 21,326            | 4.7              | 4.0              |
| Wireless service           | 38,568         | 33,692            | 30,673            | 14.5             | 9.8              |
| Directory                  | 4,806          | 5,823             | 5,689             | (17.5)           | 2.4              |
| Other                      | 11,550         | 11,861            | 12,268            | (2.6)            | (3.3)            |
| Total Operating Revenues   | \$118,928      | \$117,054         | \$116,805         | 1.6%             | 0.2%             |

The pro forma voice revenue decline is consistent with trends and is due to access line declines reflecting competition and substitution of alternative technologies, pricing pressures due to competition, anticipated shifts of traffic by major consolidated carriers to their own networks and a continuing decline in the number of ATTC's mass-market customers, which represent consumer and small business.

Pro forma data growth was led by an increase in Internet Protocol (IP) data revenues of 13.3% in 2007 and 14.1% in 2006, with strength in high-speed Internet, managed Internet, Virtual Private Network (VPN) and hosting services. Data transport service revenues were up 0.7% in 2007

**Income taxes** increased \$2,728, or 77.4%, in 2007 and \$2,593 in 2006. The increase in income taxes in 2007 was primarily due to higher operating income in 2007 reflecting the addition of BellSouth's and its share of AT&T Mobility's operating results. Our effective tax rate in 2007 was 34.4%, compared to 32.4% in 2006 and 16.3% in 2005. The increase in our effective tax rate for 2007 was primarily due to the consolidation of AT&T Mobility and an increase in income before income taxes. Prior to the consolidation of AT&T Mobility, our income before income taxes included our equity in AT&T Mobility's after-tax net income. With consolidation, the AT&T Mobility income tax expense that was previously netted in income before income taxes is now included in our consolidated income tax expense.

The increase in income tax expense in 2006 compared to 2005 was primarily due to the higher income before income taxes in 2006 and our agreement in December 2005 with the Internal Revenue Service (IRS) to settle certain claims principally related to the utilization of capital losses and tax credits for tax years 1997 – 1999. The settlement reduced income tax expense by \$902 in 2005, which also lowered our effective tax rate for 2005. (See Note 10)

### Supplemental Information

To provide improved comparability versus previous results, below is a supplemental table providing pro forma consolidated operating revenues for 2005 and 2006, assuming the closing date for the BellSouth and ATTC acquisitions was January 1, 2005.

and 3.3% in 2006, and packet-switched data revenues, which include frame relay and asynchronous transfer mode (ATM) services, were down 7.0% and 12.5%, respectively, consistent with the industry trend of customers switching to IP-based services from traditional circuit-based services.

Pro forma wireless service growth was driven by subscriber growth and strong increases in data usage, including increased messaging, browsing, downloads, media bundles and laptop and smartphone connectivity. We have historically discussed our wireless segment results on a basis that included 100% of AT&T Mobility results, and a detailed wireless service revenue discussion can be found in our "Wireless Segment Results" section.

Directory results were lower in 2007 due to the purchase accounting treatment of directories delivered by BellSouth's advertising and publishing businesses in the 12 months prior to the merger (see Note 4). In accordance with GAAP, the deferred revenues from these books were not included in the opening balance sheet and are therefore not included in the 2007 consolidated directory revenues. Had those deferred revenues been included in 2007, directory revenues would have increased by \$964. The pro forma revenues for 2005 and 2006 do not reflect this purchase accounting treatment of deferred directory revenues.

Pro forma other revenues decreased in 2007 and 2006 due to our decision to de-emphasize sales of lower-margin, stand-alone customer premises equipment.

### Segment Results

Our segments are strategic business units that offer different products and services and are managed accordingly. As a result of our acquisitions of BellSouth and ATTC, we revised our segment reporting to represent how we now manage our business, restating prior periods to conform to the current segments. Our operating segment results presented in Note 4 and discussed below for each segment follow our internal management reporting. We analyze our various operating segments based on segment income before income taxes (see Note 4). Each segment's percentage of total segment operating revenue and income calculations is derived from our segment results table in Note 4 and reflects amounts before eliminations. We have four reportable segments: (1) wireless, (2) wireline, (3) advertising & publishing and (4) other.

The **wireless segment** accounted for approximately 35% of our 2007 total segment operating revenues as compared to 37% in 2006 and 32% of our 2007 total segment income as compared to 27% in 2006. This segment offers wireless voice and data communications services across the United States, providing cellular and PCS services. This segment reflects 100% of the results reported by AT&T Mobility, which was our wireless joint venture with BellSouth prior to the December 29, 2006 acquisition and is now a wholly-owned subsidiary of AT&T. Prior to the acquisition, although we analyzed AT&T Mobility's revenues and expenses under the wireless segment, we eliminated the wireless segment in our consolidated financial statements. In our 2006 and prior consolidated financial statements we reported our 60% proportionate share of AT&T Mobility's results as equity in net income of affiliates.

The **wireline segment** accounted for approximately 59% of our 2007 total segment operating revenues as compared to 57% in 2006 and 55% of our 2007 total segment income as compared to 47% in 2006. This segment provides both retail and wholesale landline communications services,

including local and long-distance voice, switched access, IP and Internet access data, messaging services, managed networking to business customers, AT&T U-verse<sup>SM</sup> TV service (U-verse) and satellite television services through our agency agreements with EchoStar Communications Corp. (EchoStar) and the DIRECTV Group, Inc. (DIRECTV). With the BellSouth acquisition, we now provide local service in 22 states ("in-region").

The **advertising & publishing segment** accounted for approximately 5% of our 2007 total segment operating revenues as compared to 4% in 2006 and 9% of our 2007 total segment income as compared to 12% in 2006. This segment includes our directory operations, which publish Yellow and White Pages directories and sell directory and Internet-based advertising. This segment also includes the results of our Internet-based advertising business, YELLOWPAGES.COM (YPC), which was a joint venture with BellSouth prior to the December 29, 2006 acquisition and is now a wholly-owned subsidiary of AT&T. For segment reporting disclosure, we have carried forward the deferred revenue and deferred cost balances for BellSouth at the acquisition date in order to reflect how the segment is managed. This is different from consolidated reporting purposes as under Statement of Financial Accounting Standards No. 141, "Business Combinations" (FAS 141), BellSouth deferred revenue and expenses from directories published during the 12-month period ending with the December 29, 2006 acquisition date are not recognized and therefore were not included in the opening balance sheet. For management reporting purposes, we continue to amortize these balances over the life of the directory (typically 12 months). Thus, our advertising & publishing segment results for 2007 include revenues of \$964 and expenses of \$308, related to directories published in the Southeast region during 2006, prior to our acquisition of BellSouth. These amounts are eliminated in our consolidated results (see Note 4).

The **other segment** accounted for approximately 1% of our 2007 total segment operating revenues as compared to 2% in 2006 and 4% of our 2007 total segment income as compared to 14% in 2006. This segment includes results from Sterling Commerce, Inc. (Sterling), customer information services, payphone, and all corporate and other operations. Additionally, this segment includes our portion of the results from our international equity investments. Prior to December 29, 2006, this segment also included our results from AT&T Mobility as equity in net income of affiliates, as discussed above.

The following tables show components of results of operations by segment. We discuss significant segment results following each table. We discuss capital expenditures for each segment in "Liquidity and Capital Resources."

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

### Wireless Segment Results

|   | 2007     | 2006     | 2005     | Percent Change   |                  |
|---|----------|----------|----------|------------------|------------------|
|   |          |          |          | 2007 vs.<br>2006 | 2006 vs.<br>2005 |
| Segment operating revenues                |          |          |          |                  |                  |
| Service                                   | \$38,678 | \$33,788 | \$30,673 | 14.5%            | 10.2%            |
| Equipment                                 | 4,006    | 3,749    | 3,795    | 6.9              | (1.2)            |
| Total Segment Operating Revenues          | 42,684   | 37,537   | 34,468   | 13.7             | 8.9              |
| Segment operating expenses                |          |          |          |                  |                  |
| Cost of services and equipment sales      | 15,991   | 15,057   | 14,388   | 6.2              | 4.6              |
| Selling, general and administrative       | 12,594   | 11,446   | 11,645   | 10.0             | (1.7)            |
| Depreciation and amortization             | 7,079    | 6,462    | 6,608    | 9.5              | (2.2)            |
| Total Segment Operating Expenses          | 35,664   | 32,965   | 32,641   | 8.2              | 1.0              |
| Segment Operating Income                  | 7,020    | 4,572    | 1,827    | 53.5             | —                |
| Equity in Net Income (Loss) of Affiliates | 16       | 40       | (11)     | (60.0)           | —                |
| Minority Interest <sup>1</sup>            | (198)    | (169)    | (103)    | (17.2)           | (64.1)           |
| Segment Income                            | \$ 6,838 | \$ 4,443 | \$ 1,713 | 53.9%            | —                |

<sup>1</sup>Minority interest is recorded as "Other Income (Expense) – Net" in the consolidated statements of income.

### Accounting for AT&T Mobility

The wireless segment reflects 100% of the results reported by AT&T Mobility (formerly Cingular), which was our wireless joint venture with BellSouth prior to the December 29, 2006 acquisition, at which time it became a wholly-owned subsidiary of AT&T. Prior to the BellSouth acquisition (see Note 2), we accounted for our 60% economic interest in AT&T Mobility under the equity method since we shared control equally with BellSouth. This means that our consolidated results in 2006 and 2005 included our 60% share of AT&T Mobility's results in "Equity in net income of affiliates" in our consolidated statements of income. Following the BellSouth acquisition, AT&T Mobility became a wholly-owned subsidiary and AT&T Mobility's results are included as operating revenues and expenses in our consolidated statements of income. Accordingly, results from this segment for the last two days of 2006 were included in our operating revenues and expenses and not in the "Equity in net income (loss) of affiliates" line. However, for all the periods presented, the wireless segment reflects 100% of the results reported by AT&T Mobility based on the management of the business.

### Dobson Acquisition

In November 2007, we acquired Dobson Communications Corporation (Dobson). Dobson marketed wireless services under the Cellular One brand and had provided roaming services to AT&T subsidiaries since 1990. Dobson had 1.7 million subscribers across 17 states, mostly in rural and suburban areas with a population covered of more than 12.6 million people. Dobson was incorporated into our wireless operations subsequent to our acquisition. Our 2007 results included net revenue of \$141 and expense of \$109 from Dobson.

### Wireless Customer and Operating Trends

As of December 31, 2007, we served 70.1 million wireless customers, compared to 61.0 million at December 31, 2006 and 54.1 million at December 31, 2005. Approximately 70% of our wireless customer net additions in 2007 were retail

customer additions, and 75% of these additions were postpaid customer additions. Contributing to our net additions and retail customer growth was improvement in customer turnover (customer churn) levels due to our strong network performance and attractive products and services offerings, including the Apple iPhone, which were partially offset by a slowing growth rate of new wireless users reflecting a maturing domestic wireless industry. The improvement in churn levels benefited from network and customer service improvements and continued high levels of advertising. Also contributing to the increase in net additions was a significant increase in prepaid gross additions. Gross customer additions were 20.1 million in 2007, 19.2 million in 2006 and 18.5 million in 2005. Postpaid customer gross additions declined primarily due to higher postpaid market penetration and market maturation, as well as lower industry postpaid churn.

As the wireless industry continues to mature, we believe that future wireless growth will become increasingly dependent on our ability to offer innovative services, which will encourage existing customers to upgrade their current services and handsets and will attract customers from other providers, as well as on our ability to minimize customer churn. Average service revenue per user/customer (ARPU) increased 2.2% compared to 2006 primarily due to increased data services ARPU growth. In 2007, data services ARPU grew 46.9% compared to 2006. The continued increase in data revenue was related to increased use of text messaging, Internet access, e-mail and other data services, which we expect to grow as we continue expanding our third-generation (3G) services. The growth in data ARPU was partially offset by a decline in voice service ARPU of 4.1% compared to 2006, reflecting a higher percentage of prepaid and reseller customers, which provide significantly lower ARPU than postpaid customers, and continued shifts to all-inclusive rate plans that offer lower monthly charges. We expect continued pressure on voice service ARPU.

ARPU declined 1.1% in 2006 due to decreases in local service, net roaming and other revenue per customer mostly

offset by a 44.8% increase in data ARPU and increased long-distance revenue per customer. In 2006, local service revenue per customer declined primarily due to the two reasons discussed above as well as free mobile-to-mobile plans that allow our wireless customers to call other AT&T Mobility customers at no charge and, to a lesser extent, Rollover<sup>®</sup> minutes. An increase in customers on Rollover plans tends to lower ARPU, since unused minutes (and associated revenue) are deferred until subsequent months for up to one year.

The effective management of customer churn also is critical to our ability to maximize revenue growth and to maintain and improve margins. Customer churn is calculated by dividing the aggregate number of wireless customers who cancel service during each month in a period by the total number of wireless customers at the beginning of each month in that period. Our customer churn rate was 1.7% in 2007, down from 1.8% in 2006 and 2.2% in 2005. The churn rate for postpaid customers was 1.3% in 2007, down from 1.5% in 2006 and 1.9% in 2005. The decline in postpaid churn reflects higher network quality, more affordable rate plans and broader network coverage as well as exclusive devices and free mobile-to-mobile calling among our wireless customers. Churn levels were slightly negatively impacted by ongoing transition of customers from our older analog and Time Division Multiple Access (TDMA) platforms to our advanced Global System for Mobile Communication (GSM) network. We plan to cease operating our analog and TDMA networks in early 2008. The increasing mix of prepaid and reseller customers in our customer base are also expected to pressure churn rates in the future.

### Wireless Operating Results

Our wireless segment operating income margin was 16.4% in 2007, 12.2% in 2006 and 5.3% in 2005. The higher margin in 2007 was primarily due to revenue growth of \$5,147, which exceeded our increase in operating expenses of \$2,699. The higher margin in 2006 was primarily due to revenue growth of \$3,069, which exceeded our increase in operating expenses of \$324.

**Service** revenues are comprised of local voice and data services, roaming, long-distance and other revenue. Service revenues increased \$4,890, or 14.5%, in 2007 and \$3,115, or 10.2%, in 2006 and consisted of:

- Data revenue increases of \$2,692, or 63.3%, in 2007 and \$1,579, or 59.0%, in 2006. The increase in 2007 is primarily due to the increased number of data users and an increase in data ARPU of 46.9%, which primarily resulted from increased use of text messaging, e-mail, data access and media bundling services. Our significant data growth also reflects an increased number of subscribers using our 3G network. The increase in 2006 was related to increased use of text messaging and Internet access services, which resulted in an increase in data ARPU of 44.8%. Data service revenues represented approximately 18.0% of our wireless segment service revenues in 2007 and 12.6% in 2006.
- Voice revenue increases of \$2,135, or 7.3%, in 2007 and \$1,592, or 5.8%, in 2006. The increase in 2007 was primarily due to an increase in the number of average

wireless customers of approximately 12.1%, partially offset by a decline in voice ARPU of 4.1%. The increase in 2006 was primarily due to an increase in the average number of wireless customers of 11.5%, partially offset by competitive pricing pressures and the impact of various all-inclusive calling and prepaid plans. Included in voice revenues for both periods were increases in long-distance and net roaming revenue due to increased international usage.

**Equipment** revenues increased \$257, or 6.9%, in 2007 and decreased \$46, or 1.2%, in 2006. The increase in 2007 was due to higher handset revenues reflecting increased gross customer additions and customer upgrades to more advanced handsets, partially offset by increased equipment discounts and rebate activity. The slight decrease in 2006 was due to a decline in handset revenues as a result of increased rebates and equipment return credits and lower priced handsets, mostly offset by increased sales of handset units, handset upgrades and accessories.

**Cost of services and equipment sales** expenses increased \$934, or 6.2%, in 2007 and \$669, or 4.6%, in 2006. The 2007 increase was primarily due to increased equipment sales expense of \$1,140 due to the overall increase in sales as well as an increase in sales of higher-cost 3G devices, the introduction of the Apple iPhone handset and an increase in the number and per-unit cost of handset accessory sales. Total equipment costs continue to be higher than equipment revenues due to the sale of handsets below cost, through direct sales sources, to customers who committed to one-year or two-year contracts or in connection with other promotions.

Cost of services declined \$206 in 2007. This decline was due to lower interconnect, roaming and long-distance expenses related to network and systems integration and cost-reduction initiatives, as well as cost reductions from the continued migration of network usage from the T-Mobile USA (T-Mobile) network in California and Nevada to our networks in these states. Our remaining purchase commitment to T-Mobile for this transition period was \$51 at December 31, 2007. These decreases were partially offset by higher network usage, with increases in total system minutes of use (MOU) of 13.5%, and associated network system expansion and increased network equipment costs.

Expenses increased in 2006 primarily due to increases in network usage and associated network system expansion. Cost of services increased \$492, or 5.3%, in 2006 due to the following:

- Increases in network usage with a total system MOU increase of 20.6% related to the increase in customers. Additionally, average MOUs per customer increased 8.2%.
- Higher roaming and long-distance costs, partially offset by a decline in reseller expenses. The reseller decrease resulted from a decrease in MOUs on the T-Mobile network of more than 50% for 2006.
- Integration costs, primarily for network integration, of \$229.

Equipment sales expenses increased \$177, or 3.5%, in 2006 due to increased handset upgrades of 11.2% and an increase in the average cost per upgrade and accessory sold, partially offset by a decline in the average cost per handset sold to new customers.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

**Selling, general and administrative** expenses increased \$1,148, or 10.0%, in 2007 and decreased \$199, or 1.7%, in 2006.

The increase in selling, general and administrative expenses in 2007 was due to the following:

- Increases in selling expenses of \$572 due to increases in sales and advertising expenses and Apple iPhone-related costs, partially offset by a decrease in net commission expense, which was consistent with the increase in prepaid plan sales as a percentage of total retail sales.
- Increases of \$572 in customer service and other expenses primarily due to increased bad-debt expense of \$338 and other support costs of \$234, partially offset by a decline of \$191 in billing expenses, lower information technology (IT) costs and customer service expenses.
- Increases in upgrade commission and residual expenses of \$195 due to increased prepaid plan costs and higher handset upgrade activity.

The decline in selling, general and administrative expenses in 2006 was due to the following:

- Decreases in billing and bad-debt expense of \$378 primarily due to fewer account write-offs and cost-savings related to transitioning to one billing system.
- Decreases in other administrative expense of \$106 due to a decline in legal-related expenses, lower employee costs and employee-related benefits due to a decrease in the number of employees, lower IT and other professional services expense and a federal excise tax refund accrual.
- Decreases in customer service expense of \$87 due to a decline in the number of outsourced call center professionals and lower billing expenses.
- Increases of \$147 primarily related to increased prepaid card replenishment costs and higher migration and upgrade transaction costs.
- Increases in other expense of \$129 due to higher warranty, refurbishment and freight costs.

- Increases in selling expense of \$96 due to an increase in sales expense, partially offset by a decrease in net commission expenses. The decline in net commission expense was due to reductions in average activation and agent branding expense, partially offset by an increase in direct commission expense.

The expenses above also include merger integration costs of \$123 in 2006, such as employee-termination costs, rebranding and advertising and customer service and systems integration costs.

**Depreciation and amortization** increased \$617, or 9.5%, in 2007 and decreased \$146, or 2.2%, in 2006. The increase in 2007 was primarily due to an increase of \$1,522 in amortization of identifiable intangible assets related to our acquisition of BellSouth's 40% ownership interest, partially offset by declining amortization of identifiable AT&T Wireless Services, Inc. (AWE) intangible assets acquired by AT&T Mobility in 2004, which are principally amortized using the sum-of-the-months-digits method of amortization. Expenses also increased due to accelerated depreciation on TDMA assets and ongoing capital spending for network upgrades and expansion. The 2007 increase was partially offset by decreases in depreciation expense of \$905 in 2007 due to certain network assets becoming fully depreciated and purchase accounting adjustments on certain network assets related to acquiring BellSouth's 40% ownership interest of AT&T Mobility.

The decline in 2006 was due to a decline in amortization expenses of \$449 attributable to the AWE intangible assets mentioned above, which are amortized using an accelerated method of amortization. This decline was partially offset by an increase in depreciation expense of \$303 in 2006 primarily due to depreciation associated with the property, plant and equipment related to ongoing capital spending for our GSM network, which was slightly offset by expense declines due to equipment that had become fully depreciated in 2006.

### Wireline Segment Results

|   | 2007            | 2006     | 2005     | Percent Change |               |
|---|-----------------|----------|----------|----------------|---------------|
|   |                 |          |          | 2007 vs. 2006  | 2006 vs. 2005 |
| Segment operating revenues              |                 |          |          |                |               |
| Voice                                   | \$41,630        | \$33,714 | \$24,180 | 23.5%          | 39.4%         |
| Data                                    | 24,075          | 18,317   | 10,783   | 31.4           | 69.9          |
| Other                                   | 5,872           | 5,447    | 3,491    | 7.8            | 56.0          |
| <b>Total Segment Operating Revenues</b> | <b>71,577</b>   | 57,478   | 38,454   | <b>24.5</b>    | 49.5          |
| Segment operating expenses              |                 |          |          |                |               |
| Cost of sales                           | 30,214          | 26,693   | 17,464   | 13.2           | 52.8          |
| Selling, general and administrative     | 16,180          | 13,185   | 9,875    | 22.7           | 33.5          |
| Depreciation and amortization           | 13,411          | 9,676    | 7,426    | 38.6           | 30.3          |
| <b>Total Segment Operating Expenses</b> | <b>59,805</b>   | 49,554   | 34,765   | <b>20.7</b>    | 42.5          |
| <b>Segment Income</b>                   | <b>\$11,772</b> | \$ 7,924 | \$ 3,689 | <b>48.6%</b>   | —             |



## Operating Margin Trends

Our wireline segment operating income margin was 16.4% in 2007, compared to 13.8% in 2006 and 9.6% in 2005. Our wireline segment operating income increased \$3,848, or 48.6%, in 2007 and \$4,235 in 2006 primarily reflecting the addition of BellSouth's operating results in 2007 and ATTC's operating results in 2006. Results for 2007 reflect lower expenses as a result of merger synergies and the addition of higher-margined operations of BellSouth, partially offset by merger-related charges and additional amortization expense on those intangibles identified at the time of our acquisitions of BellSouth and ATTC. Our operating income continued to be pressured by access line declines due to increased competition, as customers disconnected both primary and additional lines and switched to alternative technologies, such as wireless, VoIP and cable for voice and data. Our strategy is to offset these line losses by increasing non-access-line-related revenues from customer connections for data, video and voice. For example, we have the opportunity to increase wireless segment revenues if customers choose AT&T Mobility as an alternative provider.

Operating income and margins increased in 2006 primarily due to lower expenses as a result of merger synergies partially offset by additional amortization expense on those intangibles identified at the time of our acquisition of ATTC and lower voice revenue as a result of continued in-region access line declines due to the reasons mentioned above.

**Voice** revenues increased \$7,916, or 23.5%, in 2007 and \$9,534 or 39.4%, in 2006 primarily due to the acquisitions of BellSouth and ATTC. Included in voice revenues are revenues from local voice, long-distance and local wholesale services. Voice revenues do not include VoIP revenues, which are included in data revenues.

- Local voice revenues increased \$6,831, or 38.4%, in 2007 and \$826, or 4.9%, in 2006. The increase in 2007 was primarily due to the acquisition of BellSouth, which increased local voice revenues approximately \$8,040. Local voice revenues also increased in 2007 due to pricing increases for regional telephone service, custom calling features and inside wire maintenance agreements. Local voice revenues in 2007 and 2006 were negatively impacted by expected declines in revenues from ATTC's mass-market customers to which no proactive marketing occurs and from customer demand-related declines for calling features and inside wire agreements. We expect our local voice revenue to continue to be negatively affected by increased competition, including customers shifting to competitors' alternative technologies and the disconnection of additional lines for DSL service and other reasons.
- Long-distance revenues increased \$761, or 5.3%, in 2007 primarily due to the acquisition of BellSouth, which increased long-distance revenues approximately \$2,075 and \$9,256 in 2006, primarily due to the acquisition of ATTC. Contributing to the revenue increases in 2007 and 2006 were continuing higher long-distance penetration levels in our original 13-state region. These increases were primarily offset by a continuing decrease in demand for long-distance service, mostly due to an expected decline in ATTC's mass-market customers. Our long-

distance revenue increase was also partially offset by competitive pricing for large-business customers and a decrease in demand for prepaid calling cards.

- Local wholesale revenues increased \$324, or 20.9%, in 2007 and decreased \$548, or 26.1%, in 2006. The increase in 2007 was primarily due to the acquisition of BellSouth, which increased local wholesale revenues approximately \$615. Wholesale revenue decreased in 2007 and 2006 due to industry consolidation as certain customers moved more traffic to their own networks. We expect this trend to stabilize during 2008, absent additional consolidation.

**Data** revenues increased \$5,758, or 31.4%, in 2007 primarily due to the acquisition of BellSouth, which increased data revenues approximately \$5,230, and increased \$7,534, or 69.9%, in 2006 primarily due to the acquisition of ATTC. Data revenues accounted for approximately 34% of our wireline operating revenues in 2007, 32% in 2006 and 28% in 2005. Data revenues include transport, IP and packet-switched data services.

IP data revenues increased \$3,080, or 47.6%, in 2007 primarily due to the acquisition of BellSouth, which increased IP data approximately \$2,235, and increased \$3,044, or 88.7%, in 2006 primarily due to the acquisition of ATTC. Included in IP data revenues are DSL, dedicated Internet access, VPN and other hosting services. VPN, hosting and dedicated Internet access services contributed to IP data growth in 2007 and 2006 due to continued growth in the customer base and migration from other traditional circuit-based products.

Our transport services, which include DS1s and DS3s (types of dedicated high-capacity lines) and SONET (a dedicated high-speed solution for multisite businesses), increased \$2,640, or 29.7%, in 2007 almost entirely due to the acquisition of BellSouth, which increased transport services revenues \$2,730. In 2007, SONET and other transport data revenues increased due to continuing high-speed volume growth. These increases were almost entirely offset by DS1 and DS3 revenue decreases due to continuing industry pricing pressures and higher levels of customer adjustments. In 2006, transport services revenues increased \$2,362, or 36.3%, primarily due to the acquisition of ATTC.

Our packet-switched services include frame relay, ATM and managed packet services and increased \$38, or 1.3%, in 2007 primarily due to the acquisition of BellSouth, which increased packet-switched service revenues \$265. This increase was almost entirely offset by both competitive pricing and lower demand as customers continue to shift to IP-based technology. We expect these services to continue to decline as a percentage of our overall data revenues. Packet-switched services increased \$2,128 in 2006 primarily due to the acquisition of ATTC.

**Other** operating revenues increased \$425, or 7.8%, in 2007 and \$1,956, or 56.0%, in 2006. The increases were due to incremental revenue from our acquisitions of BellSouth in 2007 and ATTC in 2006. Major items included in other operating revenues are integration services and customer premises equipment, government-related services, outsourcing and state and municipal fees, which account for more than 67% of total revenue for all periods.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

Equipment sales and related network integration and management services decreased \$274 in 2007 and \$176 in 2006 primarily due to less emphasis on the sale of lower-margin equipment. Revenue also decreased by \$70 in 2007 due to the recognition of intellectual property license fees in 2006 that did not recur in 2007.

**Cost of sales** expenses increased \$3,521, or 13.2%, in 2007 and \$9,229, or 52.8%, in 2006. The increases were primarily due to incremental expenses resulting from our acquisitions of BellSouth in 2007 and ATTC in 2006. Cost of sales consists of costs we incur in order to provide our products and services, including costs of operating and maintaining our networks and personnel costs, such as salary, wage and bonus accruals. Costs in this category include our repair technicians and repair services, certain network planning and engineering expenses, operator services, information technology and property taxes related to elements of our network. Pension and postretirement costs, net of amounts capitalized as part of construction labor, are also included to the extent that they are associated with these employees.

In addition to the impact of the BellSouth acquisition, cost of sales in 2007 increased due to the following:

- Higher nonemployee-related expenses, such as contract services, agent commissions and materials and supplies costs, of \$605.
- Higher expenses of \$225 in 2007 due to a 2006 change in our policy regarding the timing for earning vacation days, which reduced expense in 2006.
- Salary and wage merit increases and other bonus accrual adjustments of \$165.

Partially offsetting these increases, cost of sales in 2007 decreased due to:

- Lower traffic compensation expenses (for access to another carrier's network) of \$831 primarily due to migration of long-distance calls onto our network and a lower volume of calls from ATTC's declining national mass-market customer base.
- Lower net pension and postretirement cost of \$398, primarily due to changes in our actuarial assumptions, including the increase of our discount rate from 5.75% to 6.00% (a decrease to expense) and favorable investment returns on plan assets resulting in a decrease in the recognition of net losses from prior years.
- Lower cost of equipment sales and related network integration services of \$300, primarily due to less emphasis on sales of lower-margin equipment. Costs associated with equipment for large-business customers (as well as DSL) typically are greater than costs associated with services that are provided over multiple years.
- Lower expenses of \$163 in 2007 due to the discontinuance of DSL Universal Service Fund fees in the third quarter of 2006.

In addition to the impact of the ATTC acquisition, cost of sales in 2006 increased due to the following:

- Higher nonemployee-related expenses, such as contract services, agent commissions and materials and supplies costs, of \$163.

- Higher benefit expenses, consisting primarily of our combined net pension and postretirement cost, increased expense \$159, primarily due to changes in our actuarial assumptions, which included the reduction of our discount rate from 6.00% to 5.75% (which increases expense), and amortization of net losses on plan assets in prior years.
- Higher traffic compensation expenses (for access to another carrier's network) of \$109 primarily due to increased volume of local traffic (telephone calls) terminating on competitor networks and wireless customers.

Partially offsetting these increases, cost of sales in 2006 decreased due to:

- A reduction in equipment sales and related network integration services of \$418, primarily due to lower demand and as a result of the September 2005 amendment of our agreement for our co-branded AT&T | DISH Network satellite TV service. Prior to restructuring our relationship with EchoStar in September 2005, we had been recording both revenue and expenses for AT&T | DISH Network satellite TV customers, resulting in relatively high initial customer-acquisition costs.
- Lower employee levels, which decreased expenses, primarily salary and wages, by \$296.
- A change made during 2006 in our policy regarding the timing for earning vacation days decreased expenses \$225.
- Merger severance expenses in 2005 were higher than in 2006 by \$176.
- In-region weather-related repair costs incurred in 2005 that did not recur in 2006, which decreased expenses \$100 in 2006.
- Non-merger-related severance expenses in 2005, which were higher than in 2006 by \$73.

**Selling, general and administrative** expenses increased \$2,995, or 22.7%, in 2007 and \$3,310, or 33.5%, in 2006. The increases were primarily due to incremental expenses resulting from our acquisitions of BellSouth in 2007 and ATTC in 2006. Selling, general and administrative expenses consist of our provision for uncollectible accounts; advertising costs; sales and marketing functions, including our retail and wholesale customer service centers; centrally managed real estate costs, including maintenance and utilities on all owned and leased buildings; credit and collection functions; and corporate overhead costs, such as finance, legal, human resources and external affairs. Pension and postretirement costs are also included to the extent that they relate to those employees.

In addition to the impact of the BellSouth acquisition, selling, general and administrative expenses in 2007 increased due to the following:

- Salary and wage merit increases and other bonus accrual adjustments of \$102.
- Higher expenses of \$96 in 2007 due to a 2006 change in our policy regarding the timing for earning vacation days, which reduced expense in 2006.
- Higher provision for uncollectible accounts of \$80.

Partially offsetting these increases, selling, general and administrative expenses in 2007 decreased due to:

- Lower net pension and postretirement cost of \$243, primarily due to changes in our actuarial assumptions, including the increase of our discount rate from 5.75% to 6.00% (a decrease to expense) and favorable investment returns on plan assets resulting in a decrease in the recognition of net losses from prior years.
- Lower employee levels, which decreased expenses, primarily salary and wages, by \$222.
- Lower nonemployee-related expenses, such as contract services, agent commissions and materials and supplies costs, of \$148.

In addition to the impact of the ATTC acquisition, selling, general and administrative expenses in 2006 also increased due to the following:

- Other wireline segment costs of \$809 primarily due to advertising costs related to promotion of the AT&T brand name. In addition, other advertising expenses increased \$117.
- Higher nonemployee-related expenses, such as contract services, agent commissions and materials and supplies costs of \$103.
- Higher benefit expenses, consisting primarily of our combined net pension and postretirement cost, increased expense \$73, primarily due to changes in our actuarial assumptions, which included the reduction of our discount rate from 6.00% to 5.75% (which increases expense) and net losses on plan assets in prior years.

Partially offsetting these increases, selling, general and administrative expenses in 2006 decreased due to:

- ATTC merger-related asset impairment charges of \$349 and merger-related severance expense of \$107 during 2005, which resulted in lower expenses in 2006.
- Lower employee levels, which decreased expenses, primarily salary and wages, by \$239.
- A charge of \$236 in 2005 to terminate existing agreements with WilTel Communications due to our acquisition of ATTC.
- A change made during 2006 in our policy regarding the timing for earning vacation days, which decreased expenses \$96.
- Our provision for uncollectible accounts decreased \$87, as we experienced fewer losses from our retail customers and a decrease in bankruptcy filings by our wholesale customers.

**Depreciation and amortization** expenses increased \$3,735, or 38.6%, in 2007 and \$2,250, or 30.3%, in 2006 primarily due to higher depreciable and amortizable asset bases as a result of the BellSouth acquisition in 2006 and the ATTC acquisition in 2005.

#### Supplemental Information

##### Access Line, Broadband Connections and Video

**Connections Summary** Our in-region switched access lines at December 31, 2007, 2006, and 2005 are shown below and access line trends are addressed throughout this segment discussion. Because our acquisition of BellSouth has a significant effect on comparative information, we have included pro-forma amounts below as of 2006 for comparative purposes, as if the companies had been combined.

#### Wireline In-Region<sup>1</sup>

| (in 000s)  | Actual<br>2007 | Pro Forma<br>2006 | Actual<br>2006 | Actual<br>2005 |
|--|----------------|-------------------|----------------|----------------|
| <b>Switched Access Lines</b>                       |                |                   |                |                |
| Retail Consumer                                    | 35,047         | 37,120            | 25,308         | 26,683         |
| Retail Business <sup>2</sup>                       | 22,754         | 23,295            | 16,714         | 16,871         |
| <b>Retail Subtotal<sup>2</sup></b>                 | <b>57,801</b>  | <b>60,415</b>     | <b>42,022</b>  | <b>43,554</b>  |
| Percent of total switched access lines             | 93.9%          | 90.9%             | 90.7%          | 88.1%          |
| Sold to ATTC                                       | 242            | 1,293             | 1,044          | 1,638          |
| Sold to other CLECs <sup>2,3</sup>                 | 3,288          | 4,431             | 2,991          | 3,886          |
| <b>Wholesale Subtotal<sup>2</sup></b>              | <b>3,530</b>   | <b>5,724</b>      | <b>4,035</b>   | <b>5,524</b>   |
| Percent of total switched access lines             | 5.7%           | 8.6%              | 8.7%           | 11.2%          |
| <b>Payphone (Retail and Wholesale)<sup>4</sup></b> | <b>251</b>     | <b>330</b>        | <b>250</b>     | <b>335</b>     |
| Percent of total switched access lines             | 0.4%           | 0.5%              | 0.6%           | 0.7%           |
| <b>Total Switched Access Lines</b>                 | <b>61,582</b>  | <b>66,469</b>     | <b>46,307</b>  | <b>49,413</b>  |
| <b>Total Broadband Connections<sup>2,5</sup></b>   | <b>14,156</b>  | <b>12,170</b>     | <b>8,538</b>   | <b>6,921</b>   |
| Satellite service <sup>2,6</sup>                   | 2,116          | 1,507             | 689            | 513            |
| U-verse video                                      | 231            | 3                 | 3              | —              |
| <b>Video Connections</b>                           | <b>2,347</b>   | <b>1,510</b>      | <b>692</b>     | <b>513</b>     |

<sup>1</sup>Wireline in-region represents access lines served by AT&T's incumbent local exchange companies (ILECs).

<sup>2</sup>Prior period amounts restated to conform to current period reporting methodology.

<sup>3</sup>Competitive local exchange carriers (CLECs).

<sup>4</sup>Payphone lines are presented above as previously reported. Revenue from these lines is reported in the Other segment.

<sup>5</sup>Broadband connections include DSL, U-verse high-speed Internet access and satellite broadband.

<sup>6</sup>Satellite service includes connections under our agency and resale agreements with EchoStar and DIRECTV.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

### Advertising & Publishing Segment Results

|   | 2007    | 2006    | 2005    | Percent Change   |                  |
|---|---------|---------|---------|------------------|------------------|
|   |         |         |         | 2007 vs.<br>2006 | 2006 vs.<br>2005 |
| Total Segment Operating Revenues          | \$5,851 | \$3,685 | \$3,684 | 58.8%            | —                |
| Segment operating expenses                |         |         |         |                  |                  |
| Cost of sales                             | 1,733   | 1,121   | 1,104   | 54.6             | 1.5              |
| Selling, general and administrative       | 1,333   | 616     | 581     | —                | 6.0              |
| Depreciation and amortization             | 924     | 3       | 5       | —                | (40.0)           |
| Total Segment Operating Expenses          | 3,990   | 1,740   | 1,690   | —                | 3.0              |
| Segment Operating Income                  | 1,861   | 1,945   | 1,994   | (4.3)            | (2.5)            |
| Equity in Net Income (Loss) of Affiliates | —       | (17)    | (5)     | —                | —                |
| Segment Income                            | \$1,861 | \$1,928 | \$1,989 | (3.5)%           | (3.1)%           |

#### Ingenio Acquisition

In December 2007, we acquired Ingenio®, a provider of Pay Per Call® technology. Ingenio will be integrated with YPC and will allow us to better serve business directory and local search customers across our entire advertising and publishing portfolio.

#### Accounting Impacts From the BellSouth Acquisition

Prior to the BellSouth acquisition (see Note 2), we accounted for our 66% economic interest in YPC under the equity method since we shared control equally with BellSouth. Following the BellSouth acquisition, YPC became a wholly-owned subsidiary of AT&T and its results are reflected in operating revenues and expenses in our consolidated statement of income.

For segment disclosure purposes, we have carried forward deferred revenue and deferred cost balances for BellSouth in order to reflect how the segment is managed. This is different from consolidated reporting purposes as under FAS 141 BellSouth deferred revenue and expenses from directories published during the 12-month period ending with the December 29, 2006 acquisition date are not recognized and therefore were not included in the opening balance sheet (see Note 4). For management reporting purposes, we continued to amortize these balances over the life of the directory (typically 12 months). Thus, our advertising & publishing segment results include revenue of \$964 and expenses of \$308 in 2007 related to directories published in the Southeast region during 2006, prior to our acquisition of BellSouth.

#### Operating Results

Our advertising & publishing segment operating income margin was 31.8% in 2007, 52.8% in 2006 and 54.1% in 2005. The decrease in the segment operating income margin in 2007 was primarily due to the addition of BellSouth's operating results, including the amortization of BellSouth's customer lists acquired as a part of the acquisition. The decrease in the segment operating income margin in 2006 was primarily the result of increased operating expenses.

**Operating revenues** increased \$2,166, or 58.8%, in 2007, primarily due to the addition of BellSouth's operating results, which increased operating revenues approximately \$2,220 in 2007. The increase was largely driven by print advertising revenue of \$1,859 and Internet advertising revenue of \$200. Operating revenues in 2006 remained relatively unchanged.

**Operating expenses** increased \$2,250 in 2007 compared to \$50, or 3.0%, in 2006 primarily due to the addition of BellSouth's operating results, which increased total operating expenses by approximately \$2,110 in 2007. The increase in 2006 was primarily due to higher costs for Internet traffic, brand advertising and employee benefits.

**Cost of sales** increased \$612, or 54.6%, in 2007 compared to \$17, or 1.5%, in 2006, primarily due to the addition of BellSouth's operating results, which increased cost of sales by approximately \$550 in 2007. Publishing, commissions, paper and printing costs represent the majority of cost of sales expenses in 2007. The increase in 2006 was primarily due to higher costs for Internet traffic.

**Selling, general and administrative** expenses increased \$717 in 2007 compared to \$35, or 6.0%, in 2006 primarily due to the addition of BellSouth's operating results, which increased selling, general and administrative expenses by approximately \$645 in 2007. Employee, uncollectible and advertising-related expenses represent the majority of selling, general and administrative expenses in 2007. Increased expenses in 2006 were primarily due to increases in other advertising & publishing segment costs, including brand advertising and employee benefits of \$102, partially offset by lower bad-debt expense of \$74.

**Depreciation and amortization** expenses increased \$921 in 2007, resulting from the amortization of customer lists acquired as a part of the BellSouth acquisition, which increased expenses by \$915 in 2007. Depreciation and amortization expenses in 2006 remained relatively unchanged.

## Other Segment Results

|                                    | 2007    | 2006    | 2005    | Percent Change   |                  |
|------------------------------------|---------|---------|---------|------------------|------------------|
|                                    |         |         |         | 2007 vs.<br>2006 | 2006 vs.<br>2005 |
| Total Segment Operating Revenues   | \$2,234 | \$1,878 | \$1,731 | 19.0%            | 8.5%             |
| Total Segment Operating Expenses   | 1,827   | 1,485   | 1,248   | 23.0             | 19.0             |
| Segment Operating Income           | 407     | 393     | 483     | 3.6              | (18.6)           |
| Equity in Net Income of Affiliates | 676     | 2,020   | 629     | (66.5)           | —                |
| Segment Income                     | \$1,083 | \$2,413 | \$1,112 | (55.1)%          | —                |

Our other segment operating results consist primarily of Sterling, customer information services, corporate and other operations. Sterling provides business-integration software and services. In late 2007, we announced our intention to cease our retail payphone operations by the end of 2008, which is reflected in the operating revenues and expenses discussion below.

**Operating revenues** increased \$356, or 19.0%, in 2007 and \$147, or 8.5%, in 2006. The increase in 2007 was primarily due to the addition of BellSouth's other operations and increased operating revenue at Sterling, partially offset by decreased revenues from our retail payphone operations. The increase in 2006 was primarily due to increased intercompany revenue from our captive insurance company (shown as intersegment revenue in Note 4) and improved operating revenue at Sterling, partially offset by a decrease in revenue as a result of the sale of our paging subsidiary in November 2005.

**Operating expenses** increased \$342, or 23.0%, in 2007 and \$237, or 19.0%, in 2006. The increase in 2007 was primarily due to the addition of BellSouth's other operations and increased operating expenses at Sterling, partially offset by decreased expenses from our retail payphone operations. The increase in 2006 was primarily due to increased operating expenses at Sterling and at our captive insurance company, partially offset by management fees paid in 2005 that did not recur in 2006.

Prior to the December 29, 2006 close of the BellSouth acquisition, our other segment included our 60% proportionate share of AT&T Mobility results as equity in net income of affiliates. As a result of the BellSouth acquisition, we own 100% of AT&T Mobility and its results for the final two days of 2006 and for the year 2007 have been excluded from equity in net income of affiliates in this segment and in our consolidated statements of income.

Our other segment also includes our equity investments in international companies, the income from which we report as equity in net income of affiliates. Our earnings from foreign affiliates are sensitive to exchange-rate changes in the value of the respective local currencies. Our foreign investments are recorded under GAAP, which include adjustments for the purchase method of accounting and exclude certain adjustments required for local reporting in specific countries. Our equity in net income of affiliates by major investment is listed below:

|   | 2007         | 2006           | 2005         |
|---|--------------|----------------|--------------|
| América Móvil   | \$381        | \$ 274         | \$198        |
| Telmex  | 265          | 222            | 212          |
| AT&T Mobility   | —            | 1,508          | 200          |
| Other   | 30           | 16             | 19           |
| <b>Other Segment Equity in<br/>Net Income of Affiliates</b> | <b>\$676</b> | <b>\$2,020</b> | <b>\$629</b> |

**Equity in net income of affiliates** decreased \$1,344 in 2007 primarily due to a change in accounting for AT&T Mobility, the results of which are no longer included in equity in net income of affiliates in 2007 due to the acquisition of BellSouth. This decrease was partially offset by an increase of \$150 from América Móvil and Telmex primarily due to improved operating results. Equity in net income increased \$1,391 in 2006, primarily due to the improved operating results at AT&T Mobility.

### OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

**2008 Revenue Trends** We expect continued expansion of our operating revenues in 2008, reflecting continuing growth in our wireless and broadband/data services. We expect our primary driver of growth to be wireless and that all our major customer categories will continue to increase their use of Internet-based broadband/data services. For our enterprise (largest) business customers, we achieved positive growth in recurring service revenues beginning in the third quarter of 2007 and expect total enterprise revenues to grow throughout 2008. Revenue growth will also reflect the increased information and technology services to be provided for under our agreements with IBM. We also expect continued revenue growth from our small and medium business customers. We expect modest growth in our consumer wireline revenues with continuing declines in traditional access lines being offset by growth in broadband and video services. We expect solid growth in broadband revenues with improvement in ARPU as customers continue to choose higher-speed services. We expect to continue to expand our U-verse service offerings with the goal of exceeding one million subscribers in service by the end of 2008.

**2008 Expense Trends** Acquisition and related merger costs and the costs involved in providing services under the IBM agreements will adversely affect expenses in 2008. We expect that our operating income margin, adjusted to exclude these costs, will expand in 2008 due primarily to expected improvement in our revenues and continued cost-control measures. In particular, we expect to continue net workforce reductions and other previously identified merger synergies and to begin new cost-control initiatives in network operations, information technology and customer care. Expenses related to growth initiatives (see "Expected Growth Areas") will apply some pressure to our operating income margin.

**OPERATING ENVIRONMENT OVERVIEW**

AT&T subsidiaries operating within the U.S. are subject to federal and state regulatory authorities. AT&T subsidiaries operating outside the U.S. are subject to the jurisdiction of national and supranational regulatory authorities in the markets where service is provided, and regulation is generally limited to operational licensing authority for the provision of services to enterprise customers.

In the Telecommunications Act of 1996 (Telecom Act), Congress established a national policy framework intended to bring the benefits of competition and investment in advanced telecommunications facilities and services to all Americans by opening all telecommunications markets to competition and reducing or eliminating burdensome regulation. Since the Telecom Act was passed, the Federal Communications Commission (FCC) and some state regulatory commissions have maintained many of the extensive regulatory requirements applicable to our traditional wireline subsidiaries. We are actively pursuing additional legislative and regulatory measures to reduce or eliminate regulatory requirements that inhibit our ability to provide the full range of services demanded by our customers. For example, we are supporting regulatory and legislative efforts that would offer a streamlined process for new video service providers to compete with traditional cable television providers. In March 2007, the FCC released an order adopting rules that prohibit municipalities from making unnecessary and unreasonable demands on competitive video service providers, and which require prompt action by such localities on cable franchise applications by new entrants. In addition, states representing a majority of our local service access lines have adopted legislation that enables new video entrants to acquire a statewide or state-approved (as opposed to municipal-approved) franchise to offer video services. We also are supporting efforts to update regulatory treatment for retail services. Passage of legislation is uncertain and depends on many factors.

Our wireless operations are likewise subject to substantial governmental regulation. Wireless communications providers must be licensed by the FCC to provide communications services at specified spectrum frequencies within specified geographic areas and must comply with the rules and policies governing the use of the spectrum as adopted by the FCC. While wireless communications providers' prices and service offerings are generally not subject to state regulation, an increasing number of states are attempting to regulate or legislate various aspects of wireless services, such as in the area of consumer protection. Additionally, we have noted our opposition to proposals to impose "net neutrality" access regulation on wireless providers. We believe that the wireless industry is characterized by innovation, differentiation and competition among handset manufacturers, carriers and applications and that additional broadband regulation and new wholesale requirements are unnecessary given the state of competition and may be appropriate only in the case of market failure.

We expect that our capital expenditures will continue to be in the midteens as a percentage of total revenues in 2008. This amount includes capital for U-verse services, wireless high-speed networks and merger-integration projects (discussed in "Expected Growth Areas"). Despite a more positive regulatory outlook and these broadband opportunities,

increasing competition and the growth of alternative technologies such as cable, wireless and VoIP have created significant challenges for our business.

**Expected Growth Areas**

We expect our wireless services and primary wireline products to remain the most significant portion of our business and have also discussed trends affecting the segments in which we report results for these products (see "Wireless Segment Results" and "Wireline Segment Results"). Over the next few years we expect an increasing percentage of our growth to come from: (1) our wireless service, and (2) data/broadband, through existing and new services. We expect that our previous acquisitions will enable us to strengthen the reach and sophistication of our network facilities, increase our large-business customer base and enhance the opportunity to market wireless services to that customer base. Whether, or the extent to which, growth in these areas will offset declines in other areas of our business is not known.

**Wireless** Wireless is our fastest-growing revenue stream and we expect to deliver continued revenue growth in the coming years. We believe that we are at the beginning of the wireless data growth curve and that there are substantial opportunities available for next-generation converged services that combine wireless, broadband, voice and video.

Our Universal Mobile Telecommunications System/High-Speed Downlink Packet Access 3G network technology covers most major metropolitan areas of the U.S. This technology provides superior speeds for data and video services, and it offers operating efficiencies by using the same spectrum and infrastructure for voice and data on an IP-based platform. Our wireless networks also rely on digital transmission technologies known as GSM, General Packet Radio Services and Enhanced Data Rates for GSM Evolution for data communications. As of December 31, 2007, we served more than 70 million customers and are the leading provider of mobile wireless voice and data communications services in the U.S.

As the wireless industry continues to mature, we believe that future wireless growth will become increasingly dependent on our ability to offer innovative services that will encourage existing customers to upgrade their services, either by adding additional or new services, such as data enhancements, or through equipment upgrades, and will attract customers from other providers, as well as our ability to minimize customer churn. We intend to accomplish these goals by continuing to expand our network coverage, improve our network quality and offer a broad array of products and services, including exclusive devices such as the Apple iPhone and free mobile-to-mobile calling among our wireless customers. The effective management of customer churn is critical to our ability to maximize revenue growth and to maintain and improve our operating margins.

**U-verse Services** We are continuing to expand our deployment of U-verse high-speed broadband and TV services. As of December 31, 2007, we have passed approximately 8 million living units (constructed housing units as well as platted housing lots) and are marketing the services to almost 50 percent of those units. Our deployment strategy is to enter each market on a limited basis in order to ensure that all operating and back-office systems are functioning successfully and then expand within each market as we continue to

monitor these systems. In these market expansions, we expect to continue to use contracted outside labor in addition to our employees as installers; our rate of expansion will be slowed if we cannot hire and train an adequate number of qualified contractors and technicians to keep pace with customer demand or if we cannot obtain all required local building permits in a timely fashion. We also continue to work with our vendors on improving, in a timely manner, the requisite hardware and software technology. Our deployment plans could be delayed if we do not receive required equipment and software on schedule. See our "Liquidity & Capital Resources" discussion for an update on our U-verse capital spending.

We believe that our U-verse TV service is subject to federal oversight as a "video service" under the Federal Communications Act. However, some cable providers and municipalities have claimed that certain IP services should be treated as a traditional cable service and therefore subject to the applicable state and local cable regulation. Certain municipalities have refused us permission to use our existing right-of-ways to deploy or activate our U-verse-related services and products, resulting in litigation. Pending negotiations and current or threatened litigation involving municipalities could delay our deployment plans in those areas. If the courts having jurisdiction where we have significant deployments of our U-verse services were to decide that federal, state and/or local cable regulation were applicable to our U-verse services, it could have a material adverse effect on the cost, timing and extent of our deployment plans.

#### REGULATORY DEVELOPMENTS

Set forth below is a summary of the most significant developments in our regulatory environment during 2007. While these issues, for the most part, apply only to certain subsidiaries in our wireline segment, the words "we," "AT&T" and "our" are used to simplify the discussion. The following discussions are intended as a condensed summary of the issues rather than as a precise legal description of all of those specific issues.

**International Regulation** Our subsidiaries operating outside the U.S. are subject to the jurisdiction of regulatory authorities in the market where service is provided. Our licensing, compliance and advocacy initiatives in foreign countries primarily enable the provision of enterprise (i.e., large business) services. AT&T is engaged in multiple efforts with foreign regulators to open markets to competition, reduce network costs and increase our scope of fully authorized network services and products.

**Federal Regulation** A summary of significant 2007 federal regulatory developments follows.

#### Wireless

**Wireless Broadband Order** In March 2007, the FCC adopted a declaratory ruling stating that wireless broadband Internet access services are information services. The FCC's decision thus places wireless broadband Internet access service on the same largely-deregulated footing as cable and wireline broadband services.

**Order on Recommendations of the Hurricane Katrina Panel** In October 2007, the FCC issued an order revising its previously adopted rule that was designed to improve the

reliability, interoperability and recovery of telecommunications in future disasters. The original order required carriers to maintain backup power, for a specified number of hours, at certain points in the network, such as cell sites and remote terminals. The FCC revised the backup power rule due to numerous concerns raised by providers about feasibility of compliance with the original rule. Although compliance with the new rule will still require substantial effort by AT&T, it gives us additional flexibility to meet our backup power obligations by gauging compliance with reference to the original design parameters of assets, exempting assets from the backup power requirements where compliance is infeasible and permitting us to satisfy our obligations by creating a disaster recovery plan that relies on portable generators and other backup power sources.

**E911 Order** In September 2007, the FCC adopted an order (the E911 Order) that would substantially increase accuracy requirements in connection with providing the location of a caller to 911 to dispatchers of emergency services. The E911 Order will become effective in April 2008. Under FCC rules, carriers are required to attempt to deliver location data to Public Safety Answering Points (PSAPs) when callers dial 911. We use a network-based location solution that employs triangulation to estimate the location of the caller. Location data for this network-based solution must be accurate within 300 meters on 95 percent of all calls and within 100 meters on 67 percent of all calls. The current rules permit these percentages to be calculated based on all calls, network-wide, for purposes of measuring location accuracy. The E911 Order would require wireless carriers to achieve E911 location accuracy measured in each of the local areas served by the approximately 6,000 PSAPs across the country. Carriers would have until September 2012 to achieve PSAP-level accuracy, and would have to demonstrate compliance with certain incremental location accuracy benchmarks in 2008 and 2010. The PSAP-level accuracy requirement in the E911 Order is not attainable throughout our wireless network using currently available commercial technology.

We are considering all avenues for review of the E911 Order, including through an appeal or a petition for reconsideration. Depending on technological developments, the interpretation of the final order and the resolution of any appeals, we could be required to make significant capital expenditures to implement and maintain compliance with this order.

**Wireless Universal Service** Our wireless subsidiary, AT&T Mobility, is currently an Eligible Telecommunications Carrier (ETC) for purposes of receiving federal universal service support in certain states. To maintain these designations, the state must certify that the carrier is entitled to receive the funds for the subsequent calendar year based on federal and applicable state ETC requirements. We are certified for each relevant state for 2008. In May 2007, the Federal-State Joint Board on Universal Service recommended applying a funding cap to the amount of universal service support received by competitive ETCs. Moreover, in order to obtain approval for our acquisition of Dobson, we agreed to a voluntary cap on our receipt of federal universal service high-cost support. The cap will be set at the amount of wireless universal service support we received as of June 30, 2007, which was approximately \$225. Additionally, the FCC is considering an

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

order that would adopt the Joint Board's recommendation to cap all competitive ETC high-cost funding. If the FCC adopts such an order, we anticipate that our company-specific cap on high-cost support will be replaced with that industrywide cap.

### Wireline

**Video Service Order** In March 2007, the FCC issued an order adopting rules to implement the Cable Act's prohibition against local franchising authorities unreasonably refusing to award competitive franchises for the delivery of cable services, which it found had created unreasonable barriers to entry that impede the goals of increasing competition and promoting broadband deployment. This order should facilitate our entry into the video market by reducing or removing entry barriers posed by municipalities that have refused us permission to use our existing right-of-ways to deploy or activate our U-verse-related services and products. This order does not preempt state laws that streamline the franchising process by, for example, establishing state-wide cable franchises. Such laws have been enacted in over half of the states in which we operate.

**Video Program Access Order** In October 2007, the FCC released an order and Further Notice of Proposed Rule Making addressing video programming issues. The order extends for five years the exclusive contract prohibition of the Communications Act, which bans exclusive contracts for satellite cable programming and satellite broadcast programming between vertically integrated programming vendors and cable operators. The order also improves the FCC's program access complaint procedures by strengthening the discovery rules and requiring production of information necessary to adjudicate a complaint.

**Special Access** In January 2005, the FCC commenced a broad examination of the regulatory framework applicable to interstate special access services provided by price-capped local exchange carriers. In a July 2007 notice, the FCC invited interested parties to update the record in that proceeding in light of industry developments since 2005. If the FCC were to modify this regulatory framework (such as by mandating further reductions in special access rates), it might negatively impact our operating results.

**Broadband Forbearance Order** In October 2007, the FCC adopted an order eliminating some regulations and certain "Computer Inquiry" rules previously applicable to optical and packet-switched broadband transmission services provided by our operating companies. Consequently, our operating companies will no longer be subject to, among other things, the FCC's tariff filing requirements or price cap rules for Frame Relay, ATM, Ethernet, Remote Network Access, SONET, Optical Network or Wave-based broadband services. This order gives us substantial flexibility to offer individually tailored contractual arrangements that better meet our customers' needs while enabling us to reduce costs and operate more efficiently.

**Long-Distance Non-Dominance Order** In August 2007, the FCC adopted an order granting regulatory relief to AT&T, Verizon Communications Inc. (Verizon) and Qwest Communications International Inc. and their independent incumbent local exchange carrier affiliates (e.g., AT&T Connecticut). This relief allows us to provide interstate long-distance services free from both structural separation requirements

and dominant carrier regulation (e.g., tariffing and price cap requirements), subject to certain limited conditions. As a result of the FCC's order, our business units will be able to integrate functions across organizations and jointly plan business operations more efficiently than previously possible. We anticipate that this relief will lower our administrative costs and improve our responsiveness to customers. In addition, the FCC eliminated the equal access scripting requirement, which had required AT&T's customer service representatives to inform new local telephone service customers of the availability of long-distance service from other carriers and to read a list of such carriers to the customer upon request.

**State Regulation** A summary of significant 2007 state regulatory developments follows.

**Video Service Legislation** A number of states in which we operate have adopted legislation or issued clarifying opinions that will make it easier for telecommunications companies to offer video service.

**California High Cost Fund** In June 2006, the California Public Utilities Commission (CPUC) opened a rulemaking to review the California High Cost Fund B (CHCF-B). The CHCF-B program was established in 1996 and was designed to support universal service goals by ensuring that basic telephone service remains affordable in high-cost areas within the service territories of the state's major incumbent local exchange carriers, such as our AT&T subsidiaries. In September 2007, the CPUC adopted a decision that changed how the CHCF-B was calculated, which we estimate will reduce our payments from the CHCF-B by approximately \$160 in 2008 and \$260 in 2009. In the same decision, the CPUC stated that AT&T and other carriers could recover lost payments from the fund by exercising pricing flexibility to increase rates for services other than the basic residential rate (such as bundles), authorized an increase in the basic residential rate by the Consumer Price Index in 2008 and a lifting of the existing rate cap on the basic residential rate in 2009. In a December 2007 decision in the same proceeding, the CPUC established a \$100 California Advanced Services Fund to encourage the deployment of broadband facilities to unserved and underserved areas of California to become effective sometime in 2008. We are unable at this time to determine the extent to which AT&T might be able to qualify for payments from this fund.

### COMPETITION

Competition continues to increase for telecommunications and information services. Technological advances have expanded the types and uses of services and products available. In addition, lack of regulation of comparable alternatives (e.g., cable, wireless and VoIP providers) has lowered costs for alternative communications service providers. As a result, we face heightened competition as well as some new opportunities in significant portions of our business.

### Wireless

We face substantial and increasing competition in all aspects of the wireless communications industry. Under current FCC rules, six or more PCS licensees, two cellular licensees and



one or more enhanced specialized mobile radio licensees may operate in each of our markets, which results in the presence of multiple competitors. Our competitors are principally three national (Verizon Wireless, Sprint Nextel Corp. and T-Mobile) and a larger number of regional providers of cellular, PCS and other wireless communications services.

We may experience significant competition from companies that provide similar services using other communications technologies and services. While some of these technologies and services are now operational, others are being developed or may be developed in the future. We compete for customers based principally on price, service offerings, call quality, coverage area and customer service.

We are an eligible bidder in the FCC 700 MHz spectrum auctions that began in January 2008, and in 2007, we agreed to purchase additional spectrum licenses covering 196 million people in the 700 MHz frequency band. (See "Wireless Spectrum" discussed in "Other Business Matters"). The availability of this additional spectrum from the auctions could increase competition, the effectiveness of existing competition, or result in new entrants in the wireless arena.

### Wireline

Our wireline subsidiaries expect continued competitive pressure in 2008 from multiple providers in various markets, including wireless, cable and other VoIP providers, interexchange carriers and resellers. At this time, we are unable to quantify the effect of competition on the industry as a whole, or financially on this segment. However, we expect both losses of market share in local service and gains resulting from business initiatives, especially in the area of bundling of products and services, including wireless and video, large-business data services, broadband and long-distance service.

In most markets, we compete with large cable companies, such as Comcast Corporation, Cox Communications, Inc. and Time Warner Inc., for local, high-speed Internet and video services customers and other smaller telecommunications companies for both long-distance and local services customers. Substitution of wireless and Internet-based services for traditional local service lines also continues to increase.

Our wireline subsidiaries remain subject to regulation by state regulatory commissions for intrastate services and by the FCC for interstate services. In contrast, our competitors are often subject to less or no regulation in providing comparable voice and data services. Under the Telecom Act, companies seeking to interconnect to our wireline subsidiaries' networks and exchange local calls enter into interconnection agreements with us. Any unresolved issues in negotiating those agreements are subject to arbitration before the appropriate state commission. These agreements (whether fully agreed-upon or arbitrated) are then subject to review and approval by the appropriate state commission.

Recently, in a number of the states in which we operate as an ILEC, state legislatures or the state public utility commissions have concluded that the voice telecommunications market is competitive and have allowed for greater pricing flexibility for non-basic residential retail services, including bundles, promotions and new products and services. While it has been a number of years since we have been allowed to raise rates in certain states, some of these state actions have been challenged by certain parties and are pending court review.

In addition to these wholesale rate and service regulations noted above, our wireline subsidiaries (excluding rural carrier affiliates) operate under state-specific elective "price-cap regulation" for retail services (also referred to as "alternative regulation") that was either legislatively enacted or authorized by the appropriate state regulatory commission. Under price-cap regulation, price caps are set for regulated services and are not tied to the cost of providing the services or to rate-of-return requirements. Price-cap rates may be subject to or eligible for annual decreases or increases and also may be eligible for deregulation or greater pricing flexibility if the associated service is deemed competitive under some state regulatory commission rules. Minimum customer service standards may also be imposed and payments required if we fail to meet the standards.

We continue to lose access lines due to competitors (e.g., wireless, cable and VoIP providers) who can provide comparable services at lower prices because they are not subject to traditional telephone industry regulation and subsequently have lower cost structures. In response to these competitive pressures, for several years we have utilized a bundling strategy that rewards customers who consolidate their services (e.g., local and long-distance telephone, DSL, wireless and video) with us. We continue to focus on bundling wireline and wireless services, including combined packages of minutes and video service through our AT&T U-verse service and our relationships with satellite television providers. We will continue to develop innovative products that capitalize on our expanding fiber network.

Additionally, we provide local, domestic intrastate and interstate, international wholesale networking capacity and switched services to other service providers, primarily large Internet Service Providers using the largest class of nationwide Internet networks (Internet backbone), wireless carriers, CLECs, regional phone ILECs, cable companies and systems integrators. These services are subject to additional competitive pressures from the development of new technologies and the increased availability of domestic and international transmission capacity. The introduction of new products and service offerings and increasing satellite, wireless, fiber-optic and cable transmission capacity for services similar to those provided by us continues to provide competitive pressures. We face a number of international competitors, including Equant, British Telecom and SingTel; as well as competition from a number of large systems integrators, such as Electronic Data Systems.

### Advertising & Publishing

Our advertising & publishing subsidiaries face competition from approximately 100 publishers of printed directories in their operating areas. Direct and indirect competition also exists from other advertising media, including newspapers, radio, television and direct-mail providers, as well as from directories offered over the Internet. We actively compete on the Internet through our wholly-owned subsidiary, YPC.

### ACCOUNTING POLICIES AND STANDARDS

**Significant Accounting Policies and Estimates** Because of the size of the financial statement line items they relate to, some of our accounting policies and estimates have a more

significant impact on our financial statements than others. The policies below are presented in the order in which the topics appear in our consolidated statements of income.

**Allowance for Uncollectibles** We maintain an allowance for doubtful accounts for estimated losses that result from the failure of our customers to make required payments. When determining the allowance, we consider the probability of recoverability based on past experience, taking into account current collection trends; as well as general economic factors, including bankruptcy rates. Credit risks are assessed based on historical write-offs, net of recoveries, and an analysis of the aged accounts receivable balances with reserves generally increasing as the receivable ages. Accounts receivable may be fully reserved for when specific collection issues are known to exist, such as pending bankruptcy or catastrophes. The analysis of receivables is performed monthly and the bad-debt allowances are adjusted accordingly. A 10% change in the amounts estimated to be uncollectible would result in a change in uncollectible expense of approximately \$140.

**Pension and Postretirement Benefits** Our actuarial estimates of retiree benefit expense and the associated significant weighted-average assumptions are discussed in Note 11. One of the most significant of these assumptions is the return on assets assumption, which was 8.5% for the year ended December 31, 2007. This assumption will remain unchanged for 2008. If all other factors were to remain unchanged, we expect that a 1% decrease in the expected long-term rate of return would cause 2008 combined pension and postretirement cost to increase \$814 over 2007. The 10-year return on our pension plan assets was 9.18% through 2007. Under GAAP, the expected long-term rate of return is calculated on the market-related value of assets (MRVA). GAAP requires that actual gains and losses on pension and postretirement plan assets be recognized in the MRVA equally over a period of up to five years. We use a methodology, allowed under GAAP, under which we hold the MRVA to within 20% of the actual fair value of plan assets, which can have the effect of accelerating the recognition of excess actual gains and losses into the MRVA in less than five years. This methodology did not have a significant additional effect on our 2007, 2006 or 2005 combined net pension and postretirement costs. Note 11 also discusses the effects of certain changes in assumptions related to medical trend rates on retiree health care costs.

**Depreciation** Our depreciation of assets, including use of composite group depreciation and estimates of useful lives, is described in Notes 1 and 5. We assign useful lives based on periodic studies of actual asset lives. Changes in those lives with significant impact on the financial statements must be disclosed, but no such changes have occurred in the three years ended December 31, 2007. However, if all other factors were to remain unchanged, we expect that a one-year increase in the useful lives of the largest categories of our plant in service (which accounts for more than three-fourths of our total plant in service) would result in a decrease of between approximately \$1,810 and \$1,860 in our 2008 depreciation expense and that a one-year decrease would result in an increase of between \$2,230 and \$2,330 in our 2008 depreciation expense.

**Asset Valuations and Impairments** We account for acquisitions using the purchase method as required by FAS 141. Under FAS 141, we allocate the purchase price to the assets acquired and liabilities assumed based on their estimated fair values. The estimated fair values of intangible assets acquired are based on the expected discounted cash flows of the identified customer relationships, patents, trade-names and licenses. In determining the future cash flows we consider demand, competition and other economic factors.

Customer relationships, which are finite-lived intangible assets, are primarily amortized using the sum-of-the-months-digits method of amortization over the period in which those relationships are expected to contribute to our future cash flows. The sum-of-the-months-digits method is a process of allocation, not of valuation, and reflects our belief that we expect greater revenue generation from these customer relationships during the earlier years of their lives. Alternatively, we could have chosen to amortize customer relationships using the straight-line method, which would allocate the cost equally over the amortization period. Amortization of other intangibles, including patents and amortizable tradenames, is determined using the straight-line method of amortization over the expected remaining useful lives. We do not amortize indefinite-lived intangibles, such as wireless FCC licenses or certain tradenames. (See Note 6)

Goodwill is not amortized but is tested for impairment in accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (FAS 142). We review goodwill, indefinite-lived intangibles and other long-lived assets for impairment under FAS 142 or Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" either annually or whenever events or circumstances indicate that the carrying amount may not be recoverable over the remaining life of the asset or asset group. In order to determine that the asset is recoverable, we verify that the expected future cash flows directly related to that asset exceed its fair value, which is based on the undiscounted cash flows. The discounted cash flow calculation uses various assumptions and estimates regarding future revenue, expense and cash flows projections over the estimated remaining useful life of the asset.

Cost investments are evaluated to determine whether mark-to-market declines are temporary and reflected in other comprehensive income, or other than temporary and recorded as an expense in the income statement. This evaluation is based on the length of time and the severity of decline in the investment's value.

**Income Taxes** Our estimates of income taxes and the significant items giving rise to the deferred assets and liabilities are shown in Note 10 and reflect our assessment of actual future taxes to be paid on items reflected in the financial statements, giving consideration to both timing and probability of these estimates. Actual income taxes could vary from these estimates due to future changes in income tax law or results from the final review of our tax returns by federal, state or foreign tax authorities. We have considered these potential changes and, for years prior to 2007, have provided amounts within our deferred tax assets and liabilities

that reflect our judgment of the probable outcome of tax contingencies (see Note 10). In 2007, we adopted Financial Accounting Standards Board Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN 48) and began accounting for uncertain tax positions under the provisions of FIN 48 (see Note 1). As required by FIN 48, we use our judgment to determine whether it is more likely than not that we will sustain positions that we have taken on tax returns and, if so, the amount of benefit to initially recognize within our financial statements. We regularly review our uncertain tax positions and adjust our unrecognized tax benefits in light of changes in facts and circumstances, such as changes in tax law, interactions with taxing authorities and developments in case law. These adjustments to our unrecognized tax benefits may affect our income tax expense. Settlement of uncertain tax positions may require use of our cash.

### **New Accounting Standards**

**FAS 141(R)** In December 2007, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141 (revised 2007), "Business Combinations" (FAS 141(R)). FAS 141(R) is a revision of FAS 141 and requires that costs incurred to effect the acquisition (i.e., acquisition-related costs) be recognized separately from the acquisition. In addition, in accordance with FAS 141, restructuring costs that the acquirer expected but was not obligated to incur, which included changes to benefit plans, were recognized as if they were a liability assumed at the acquisition date. FAS 141(R) requires the acquirer to recognize those costs separately from the business combination. We are currently evaluating the impact that FAS 141(R) has on our accounting for acquisitions prior to the effective date of the first fiscal year beginning after December 15, 2008.

**FAS 159** In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (FAS 159). FAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value, thereby providing the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. FAS 159 is effective for fiscal years beginning after November 15, 2007. We elected not to adopt the fair value option for valuation of those assets and liabilities which are eligible, therefore there is no impact on our financial position and results of operations.

**FAS 160** In December 2007, the FASB issued Statement of Financial Accounting Standards No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51" (FAS 160). FAS 160 requires noncontrolling interests held by parties other than the parent in subsidiaries be clearly identified, labeled, and presented in the consolidated statement of financial position within equity, but separate from the parent's equity. FAS 160 is effective for fiscal years beginning after December 15, 2008. We are currently evaluating the impact FAS 160 will have on our financial position and results of operations.

**EITF 06-4** In March 2007, the Emerging Issues Task Force (EITF) ratified the consensus on EITF 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"

(EITF 06-4). EITF 06-4 covers endorsement split-dollar life insurance arrangements (where the company owns and controls the policy) and provides that an employer should recognize a liability for future benefits in accordance with Statement of Financial Accounting Standards No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." EITF 06-4 is effective for fiscal years beginning after December 15, 2007. We are currently evaluating the impact EITF 06-4 will have on our financial position and results of operations.

**EITF 06-11** In June 2007, the EITF ratified the consensus on EITF 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards" (EITF 06-11). EITF 06-11 provides that a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for nonvested equity-classified share-based awards and equity-classified outstanding share options should be recognized as an increase to additional paid-in capital rather than a reduction of income tax expense. EITF 06-11 applies prospectively to the income tax benefits that result from dividends on equity-classified employee share-based payment awards that are declared in fiscal periods beginning after December 15, 2007. EITF 06-11 will not have a material impact on our financial position and results of operations.

### **OTHER BUSINESS MATTERS**

**Spectrum Licenses** In October 2007, we agreed to purchase spectrum licenses covering 196 million people in the 700 MHz frequency band from Aloha Partners, L.P. for \$2,500. The spectrum covers many major metropolitan areas, including 72 of the top 100 and all of the top 10 markets in the U.S. We closed this transaction in February 2008. Additionally, we are an eligible bidder in the FCC wireless spectrum auctions which began in January 2008.

**Spectrum Sale** In February 2007, we agreed to sell to Clearwire Corporation (Clearwire), a national provider of wireless broadband Internet access, education broadband service spectrum and broadband radio service spectrum valued at \$300. The transaction received the necessary regulatory approvals and closed in May 2007. Sale of this spectrum was required as a condition to the approval of our acquisition of BellSouth.

**Antitrust Litigation** In 2002, two consumer class-action antitrust cases were filed in the United States District Court for the Southern District of New York (District Court) against SBC Communications Inc., Verizon, BellSouth and Qwest Communications International Inc. alleging that they have violated federal and state antitrust laws by agreeing not to compete with one another and acting together to impede competition for local telephone services (Twombly v. Bell Atlantic Corp., et al.). In October 2003, the District Court granted the joint defendants' motion to dismiss and the plaintiffs appealed. In October 2005, the United States Court of Appeals for the Second Circuit Court (Second Circuit) reversed the District Court, thereby allowing the cases to proceed. In June 2006, the Supreme Court of the United States (Supreme Court) announced its decision to review the case. In May 2007, the Supreme Court reversed the Second Circuit's decision and remanded the case to the Second Circuit for further proceedings consistent with its opinion; we are awaiting formal dismissal of the case.

**Retiree Phone Concession Litigation** In May 2005, we were served with a purported class action in U.S. District Court, Western District of Texas (Stoffels v. SBC Communications Inc.), in which the plaintiffs, who are retirees of Pacific Bell Telephone Company, Southwestern Bell, and Ameritech, contend that the telephone concession provided by the company is, in essence, a "defined benefit plan" within the meaning of the Employee Retirement Income Security Act of 1974, as amended (ERISA). On October 3, 2006, the Court certified two classes. The issue of whether the concession is an ERISA pension plan was tried before the judge the week of November 26, 2007. The court has rendered no decision. We believe that an adverse outcome having a material effect on our financial statements in this case is unlikely, but will continue to evaluate the potential impact of this suit on our financial results as it progresses.

**NSA Litigation** There are 24 pending lawsuits that allege that we and other telecommunications carriers unlawfully provided assistance to the National Security Agency (NSA) in connection with intelligence activities that were initiated following the events of September 11, 2001. In the first filed case, Hepting et al v. AT&T Corp., AT&T Inc. and Does 1-20, a purported class action filed in U.S. District Court in the Northern District of California, plaintiffs allege that the defendants have disclosed and are currently disclosing to the U.S. Government content and call records concerning communications to which Plaintiffs were a party. Plaintiffs seek damages, a declaratory judgment, and injunctive relief for violations of the First and Fourth Amendments to the United States Constitution, the Foreign Intelligence Surveillance Act, the Electronic Communications Privacy Act, and other federal and California statutes. We filed a motion to dismiss the complaint. The United States asserted the "state secrets privilege" and related statutory privileges and also filed a motion asking the court to either dismiss the complaint or issue a summary judgment in favor of the defendants. The Court denied the Motions to Dismiss of both parties. Specifically, the Court ruled that the state secrets privilege does not prevent AT&T from asserting any statutory defense it may have, as appropriate, regarding allegations that it assisted the government in monitoring communication content. However, with regard to the calling records allegations, the Court noted that it would not require AT&T to disclose what relationship, if any, it has with the government. We and the U.S. government filed interlocutory appeals in July 2006. The case was argued before a panel of the U.S. Court of Appeals for the Ninth Circuit on August 15, 2007. We are awaiting a decision. Management believes these actions are without merit and intends to vigorously defend these matters.

**Prepaid Calling Card Patent Litigation** On September 14, 2007, a jury in Texas found that ATTC willfully infringed two patents owned by TGIP Inc. (TGIP) relating to point-of-sale prepaid cards sold by ATTC and awarded TGIP \$156 in damages. (TGIP Inc. v. AT&T Corp. et al., U.S. District Court for the Eastern District of Texas). The jury's finding of willfulness also entitled TGIP to ask the judge to award additional damages up to treble the jury verdict. On September 28, 2007, AT&T filed a motion requesting that the Court overturn the jury's verdict as a matter of law. On October 29, 2007, the Court overturned the jury's finding of infringement, the jury's \$156 award of damages and the jury's finding of willfulness. TGIP has appealed the Court's decision and oral argument

on their appeal is likely to be held later in the third quarter of 2008.

**Broadcom Patent Dispute** A number of our handsets, as well as those provided by other wireless carriers, are subject to a patent dispute at the U.S. International Trade Commission (ITC) between Broadcom Corporation and Qualcomm Incorporated (Qualcomm). Currently, the U.S. ITC's exclusion order applicable to certain Qualcomm technology is stayed pending a decision by the appeals court. We anticipate a decision will not occur before late in the second quarter of 2008. We continue to take steps to mitigate the effects on us. However, if no resolution were to occur, future costs and availability of handsets using Qualcomm chips could be adversely affected.

#### LIQUIDITY AND CAPITAL RESOURCES

We had \$1,970 in cash and cash equivalents available at December 31, 2007. Cash and cash equivalents included cash of \$889 and money market funds and other cash equivalents of \$1,081. Cash and cash equivalents decreased \$448 since December 31, 2006. During 2007, cash inflow was primarily provided by cash receipts from operations, the issuance of long-term debt, net cash received from dispositions of non-strategic real estate and the sale of marketable securities and other assets. These inflows were offset by cash used to meet the needs of the business including, but not limited to, payment of operating expenses, funding capital expenditures, repurchase of common shares, the repayment of debt, dividends to stockholders and payment of interest on debt. We discuss many of these factors in detail below.

#### Cash Provided by or Used in Operating Activities

During 2007, cash provided by operating activities was \$34,072 compared to \$15,615 in 2006. Operating cash flows increased primarily due to an increase in operating income reflecting additional cash provided by the BellSouth acquisition and our success in achieving merger synergies and operational efficiencies, partially offset by increased interest payments of approximately \$1,800 and tax payments of \$1,200. During 2007, tax payments were higher due primarily to a \$1,000 deposit related to the IRS examination of our 2000 – 2002 income tax returns. The timing of cash payments for income taxes, which is governed by the IRS and other taxing jurisdictions, will differ from the timing of recording tax expense and deferred income taxes, which are reported in accordance with GAAP.

During 2006, our primary source of funds was cash from operating activities of \$15,615 compared to \$12,974 in 2005. Operating cash flows increased primarily due to an increase in net income of more than \$2,500 and additional cash provided by the ATTC acquisition, partially offset by increased tax payments of \$739 in 2006. Tax payments were higher primarily due to increased income before income taxes. Tax payments in 2006, include a refund from the completion of the ATTC federal income tax audit covering 1997 – 2001.

#### Cash Used in or Provided by Investing Activities

During 2007, cash used in investing activities consisted of:

- \$17,717 in construction and capital expenditures.
- \$2,200, net of cash acquired, related to the acquisition of Dobson, a provider of rural and suburban wireless communications services.
- \$579 for investments in debt and equity securities.

- \$316 related to the acquisition of Ingenio, a provider of Pay Per Call search and directory solutions, and Interwise, a provider of voice, Web and video conferencing services.
- \$190 to satisfy an obligation to Alaska Native Wireless, LLC to acquire wireless spectrum and the acquisition of an additional ownership interest in Cellular Communications of Puerto Rico.
- \$136 related to the acquisition of wireless and media rights, intellectual property and other strategic assets.

In October 2007, we agreed to purchase spectrum licenses in the 700 MHz frequency band from Aloha Partners, L.P. for approximately \$2,500. We closed this transaction in February 2008. Additionally, we are an eligible bidder in the FCC wireless spectrum auctions which began in January 2008.

Net cash provided by investing activities for 2007 was \$2,663 and consisted of net proceeds of \$1,594 from dispositions of non-strategic assets, \$1,033 from the sale of marketable and equity securities and \$36 related to other activities. Proceeds from dispositions included the following:

- \$1,137 from the sale of properties and other non-strategic assets.
- \$301 from the sale of spectrum to Clearwire Corporation, which includes interest.
- \$156 related to T-Mobile's exercise of its option to purchase an additional 10 MHz of spectrum in the San Diego market, the sale of cost investments and the sale of wireless towers.

To provide high-quality communications services to our customers, we must make significant investments in property, plant and equipment. The amount of capital investment is influenced by demand for services and products, continued growth and regulatory considerations. Capital expenditures in the wireline segment, which represented approximately 77% of our capital expenditures, increased 68% in 2007, reflecting the acquisition of BellSouth. Our capital expenditures are primarily for our wireline subsidiaries' networks, our U-verse services, merger-integration projects and support systems for our long-distance service. Because of opportunities made available by the continued changing regulatory environment and our acquisitions of ATTC and BellSouth, we expect that our capital expenditures for 2008, which include wireless network expansion and U-verse services, will be in the midteens as a percentage of consolidated revenue. We expect to fund 2008 capital expenditures for our wireline and wireless segments, including international operations, using cash from operations and incremental borrowings depending on interest rate levels and overall market conditions.

During 2007, we spent \$3,745 in the wireless segment primarily for Universal Mobile Telecommunications System/High-Speed Packet Access (UMTS/HSPA) network expansion, GSM/EDGE (Enhanced Data Rates for Global Evolution) network capacity expansion and upgrades, as well as for IT and other support systems for our wireless service. The network capacity requirements and expansion of our UMTS/HSPA wireless networks will continue to require substantial amounts of capital through 2008. In 2008, our wireless capital expenditures should be in the lower double-digit range as a percent of our wireless revenues for the integration and expansion of our networks and the installation of UMTS/HSPA technology in a number of markets.

We spent approximately \$2,500 on our U-verse services in 2007 and expect spending to be approximately \$2,500 in 2008 for capital expenditures on our U-verse services for initial network-related deployment costs. We expect to pass approximately 30 million living units by the end of 2010. Additional customer activation capital expenditures are not included in this capital spending forecast. We expect that the business opportunities made available, specifically in the data/broadband area, will allow us to expand our products and services (see "U-verse Services" discussed in "Expected Growth Areas").

The other segment capital expenditures were less than 1.5% of total capital expenditures for 2007. Included in the other segment are equity investments, which should be self-funding as they are not direct AT&T operations; as well as corporate, diversified business and Sterling operations, which we expect to fund using cash from operations. We expect to fund any advertising & publishing segment capital expenditures using cash from operations.

#### **Cash Used in or Provided by Financing Activities**

We plan to fund our 2008 financing activities through a combination of debt issuances and cash from operations. Our financing activities include funding share repurchases and the repayment of debt. We will continue to examine opportunities to fund our activities by issuing debt at favorable rates and with cash from the disposition of certain other non-strategic investments.

On March 4, 2006, our Board of Directors authorized the repurchase of up to 400 million shares of AT&T common stock. During 2007, we repurchased 267 million shares at a cost of \$10,390. Share repurchases under this plan totaled approximately 351 million shares at a cost of \$13,068. On December 10, 2007, our Board of Directors authorized a new share repurchase plan of 400 million shares, which replaces our previous share repurchase authorization. This new authorization represents approximately 6.6 percent of AT&T's shares outstanding at December 31, 2007 and expires at the end of 2009. We have repurchased, and intend to continue to repurchase, a portion of the shares pursuant to plans that comply with the requirements of Rule 10b5-1(c) under the Securities Exchange Act of 1934. We will fund our additional share repurchases through a combination of cash from operations, borrowings dependent upon market conditions, and cash from the disposition of certain non-strategic investments.

We paid dividends of \$8,743 in 2007, \$5,153 in 2006 and \$4,256 in 2005, reflecting the issuance of additional shares for the BellSouth and ATTC acquisitions and dividend increases. In December 2007, our Board of Directors approved a 12.7% increase in the quarterly dividend from \$0.355 to \$0.40 per share. This increase recognizes our strong growth and positive outlook and follows a 6.8% dividend increase approved by AT&T's Board in December 2006. Dividends declared by our Board of Directors totaled \$1.465 per share in 2007, \$1.35 per share in 2006 and \$1.30 per share in 2005. Our dividend policy considers both the expectations and requirements of stockholders, internal requirements of AT&T and long-term growth opportunities. It is our intent to provide the financial flexibility to allow our Board of Directors to consider dividend growth and to recommend an increase in dividends to be paid in future periods. All dividends remain subject to approval by our Board of Directors.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

At December 31, 2007, we had \$6,860 of debt maturing within one year, which included \$4,939 of long-term debt maturities and \$1,921 of commercial paper borrowings and other borrowings. All of our commercial paper borrowings are due within 90 days. We continue to examine our mix of short- and long-term debt in light of interest rate trends.

During 2007, we received net proceeds of \$11,367 from the issuance of \$11,499 in long-term debt. Debt proceeds were used for general corporate purposes and parts of the proceeds were used for repurchases of our common stock. Long-term debt issuances consisted of:

- \$2,000 of 6.3% global notes due in 2038.
- \$2,000 of 6.5% global notes due in 2037.
- €1.25 billion of 4.375% notes due in 2013 (equivalent to U.S. \$1,641 when issued).
- \$1,500 of floating-rate notes due in 2010.
- \$1,200 of 6.375% retail notes due in 2056.
- £600 million of 5.5% notes due in 2027 (equivalent to U.S. \$1,158 when issued).
- \$1,000 of 4.95% global notes due in 2013.
- \$500 of 5.625% notes due in 2016.
- \$500 of zero-coupon puttable notes due in 2022.

In February 2008, we received net proceeds of \$3,972 from the issuance of \$4,000 in long-term debt. The long-term debt issued consisted of the following:

- \$2,500 of 5.5% global notes due in 2018.
- \$750 of 4.95% global notes due in 2013.
- \$750 of 6.3% global notes due in 2038.

Beginning in May 2009, the \$500 zero-coupon puttable note may be presented for redemption by the holder at specified dates but not more frequently than annually, excluding 2011. If the note is held to maturity in 2022, the redemption amount will be \$1,030.

We entered into fixed-to-fixed cross-currency swaps on our two foreign-currency-denominated debt instruments to hedge our exposure to changes in foreign currency exchange rates. These hedges also include interest rate swaps of a fixed foreign-denominated rate to a fixed U.S.-denominated interest rate, which results in a U.S.-denominated rate of 5.31% on our Euro-denominated notes and 5.97% on our British pound sterling-denominated notes.

During 2007, debt repayments totaled \$10,183 and consisted of:

- \$3,871 related to debt repayments with a weighted-average interest rate of 6.1%, which included the early redemption of debt related to a put exercise on \$1,000 of our 4.2% Puttable Reset Securities and called debt of \$500 with an interest rate of 7.0%.
- \$3,411 related to repayments of commercial paper and other short-term bank borrowings.
- \$1,735 related to the early redemption of Dobson debt acquired with a par value of \$1,599 and a weighted-average interest rate of 9.1%.
- \$904 related to the early repayment of a Dobson long-term credit facility.
- \$218 related to the early redemption of a convertible note held by Dobson.
- \$44 related to scheduled principal payments on other debt and repayments of other borrowings.

We have a five-year \$10,000 credit agreement with a syndicate of investment and commercial banks, which we have the right to increase up to an additional \$2,000, provided

no event of default under the credit agreement has occurred. The current agreement will expire in July 2011. We also have the right to terminate, in whole or in part, amounts committed by the lenders under this agreement in excess of any outstanding advances; however, any such terminated commitments may not be reinstated. Advances under this agreement may be used for general corporate purposes, including support of commercial paper borrowings and other short-term borrowings. There is no material adverse change provision governing the drawdown of advances under this credit agreement. This agreement contains a negative pledge covenant, which requires that, if at any time we or a subsidiary pledge assets or otherwise permits a lien on its properties, advances under this agreement will be ratably secured, subject to specified exceptions. We must maintain a debt-to-EBITDA (earnings before interest, income taxes, depreciation and amortization, and other modifications described in the agreement) financial ratio covenant of not more than three-to-one as of the last day of each fiscal quarter for the four quarters then ended. We comply with all covenants under the agreement. At December 31, 2007, we had no borrowings outstanding under this agreement. (See Note 8)

During 2007, proceeds of \$1,986 from the issuance of treasury shares were related to the exercise of stock-based compensation.

During 2007, we paid \$190 to minority interest holders and \$47 to terminate interest rate swaps with notional amounts totaling \$1,800 acquired as a result of our acquisition of BellSouth.

### Other

Our total capital consists of debt (long-term debt and debt maturing within one year) and stockholders' equity. Our capital structure does not include debt issued by our international equity investees. Our debt ratio was 35.7%, 34.1% and 35.9% at December 31, 2007, 2006 and 2005. The debt ratio is affected by the same factors that affect total capital. Total capital increased \$4,146 in 2007 compared to more than \$90,000 in 2006. The 2007 total capital increase was due to an increase in debt of \$4,319 related to our financing activities. Our stockholders' equity balance was down \$173 and included our increase in net income and current adjustments for unrealized pension and postretirement gains, which were more than offset by our increased share repurchase activity and dividend distributions.

The primary factor contributing to the decline in our 2006 debt ratio was the acquisition of BellSouth, which increased our stockholders' equity approximately 105% and our total long-term debt by 96%. The 2006 total capital increase was primarily due to the purchase of BellSouth (see Note 2). For 2006, our common stock outstanding and capital in excess of par value increased by \$60,850 and our current and long-term debt increased by \$29,226. The increase in total debt was primarily due to acquired debt from BellSouth and AT&T Mobility of \$28,321, an increase in commercial paper and other short-term borrowings of \$3,649 and debt issuances of \$1,500, partially offset by long-term debt repayments of \$4,242 during 2006. Stockholders' equity also increased due to our net income and was partially offset by dividend payments and our repurchases of common shares through our stock repurchase program.

## CONTRACTUAL OBLIGATIONS, COMMITMENTS AND CONTINGENCIES

Current accounting standards require us to disclose our material obligations and commitments to making future payments under contracts, such as debt and lease agreements, and under contingent commitments, such as debt guarantees. We occasionally enter into third-party debt guarantees, but they are not, nor are they reasonably likely to become, material. We disclose our contractual long-term debt repayment obligations in Note 8 and our operating lease payments in Note 5. Our contractual obligations do not include expected pension and postretirement payments as we maintain pension funds and Voluntary Employee Beneficiary Association trusts to fully or partially fund these benefits (see Note 11). In the ordinary course of business we routinely enter into commercial commitments for various aspects of our operations, such as plant additions and office supplies. However, we do not believe that the commitments will have a material effect on our financial condition, results of operations or cash flows.

Our contractual obligations as of December 31, 2007, are in the following table. The purchase obligations that follow are those for which we have guaranteed funds and will be funded with cash provided by operations or through incremental borrowings. The minimum commitment for certain obligations is based on termination penalties that could be paid to exit the contract. Since termination penalties would not be paid every year, such penalties are excluded from the

table. Other long-term liabilities were included in the table based on the year of required payment or an estimate of the year of payment. Such estimate of payment is based on a review of past trends for these items, as well as a forecast of future activities. Certain items were excluded from the following table as the year of payment is unknown and could not be reliably estimated since past trends were not deemed to be an indicator of future payment.

Substantially all of our purchase obligations are in our wireline and wireless segments. The table does not include the fair value of our interest rate swaps. Our capital lease obligations have been excluded from the table due to the immaterial value at December 31, 2007. Many of our other noncurrent liabilities have been excluded from the following table due to the uncertainty of the timing of payments, combined with the absence of historical trending to be used as a predictor of such payments. Additionally, certain other long-term liabilities have been excluded since settlement of such liabilities will not require the use of cash. However, we have included in the following table obligations which primarily relate to benefit funding and severance due to the certainty of the timing of these future payments. Our other long-term liabilities are: deferred income taxes (see Note 10) of \$24,939; postemployment benefit obligations (see Note 11) of \$24,011; and other noncurrent liabilities of \$14,648, which included deferred lease revenue from our agreement with American Tower of \$539 (see Note 5).

### Contractual Obligations

|  | Payments Due By Period |                     |                 |                 |                      |
|--|------------------------|---------------------|-----------------|-----------------|----------------------|
|  | Total                  | Less than<br>1 Year | 1-3<br>Years    | 3-5<br>Years    | More than<br>5 Years |
| Long-term debt obligations <sup>1</sup>  | \$ 59,856              | \$ 4,926            | \$ 9,731        | \$12,428        | \$32,771             |
| Interest payments on long-term debt      | 54,835                 | 3,582               | 6,562           | 5,151           | 39,540               |
| Commercial paper obligations             | 1,859                  | 1,859               | —               | —               | —                    |
| Other short-term borrowings              | 62                     | 62                  | —               | —               | —                    |
| Operating lease obligations              | 15,147                 | 2,088               | 3,479           | 2,622           | 6,958                |
| Unrecognized tax benefits <sup>2</sup>   | 6,579                  | 685                 | —               | —               | 5,894                |
| Purchase obligations <sup>3,4</sup>      | 6,366                  | 2,461               | 2,237           | 1,197           | 471                  |
| Other long-term obligations <sup>5</sup> | 429                    | 188                 | 228             | 13              | —                    |
| <b>Total Contractual Obligations</b>     | <b>\$145,133</b>       | <b>\$15,851</b>     | <b>\$22,237</b> | <b>\$21,411</b> | <b>\$85,634</b>      |

<sup>1</sup>The impact of premiums/discounts and derivative instruments included in debt amounts on the balance sheet are excluded from the table.

<sup>2</sup>The non-current portion of the unrecognized tax benefits is included in the "More than 5 Years" column as we cannot reasonably estimate the timing or amounts of additional cash payments, if any, at this time. See Note 10 for additional information.

<sup>3</sup>We have contractual obligations to utilize network facilities from local exchange carriers with terms greater than one year. Since the contracts have no minimum volume requirements and are based on an interrelationship of volumes and discounted rates, we assessed our minimum commitment based on penalties to exit the contracts, assuming that we had exited the contracts on December 31, 2007. At December 31, 2007, the penalties we would have incurred to exit all of these contracts would have been \$703. These termination fees could be \$374 in 2008, \$132 in the aggregate for 2009 and 2010 and \$4 for 2011, assuming that all contracts are exited. These termination fees are excluded from the above table as the fees would not be paid every year and the timing of such payments, if any, is uncertain.

<sup>4</sup>We calculated the minimum obligation for certain agreements to purchase goods or services based on termination fees that can be paid to exit the contract. If we elect to exit these contracts, termination fees for all such contracts in the year of termination could be approximately \$642 in 2008, \$720 in the aggregate for 2009 and 2010, \$257 in the aggregate for 2011 and 2012 and \$137 in the aggregate, thereafter. Certain termination fees are excluded from the above table as the fees would not be paid every year and the timing of such payments, if any, is uncertain.

<sup>5</sup>Other long-term obligations include commitments with local exchange carriers for dedicated leased lines.

### MARKET RISK

We are exposed to market risks primarily from changes in interest rates and foreign currency exchange rates. In managing exposure to these fluctuations, we may engage in various hedging transactions that have been authorized according to documented policies and procedures. On a limited basis, we use certain derivative financial instruments, including foreign currency exchange contracts and combined interest rate foreign currency contracts, to manage these risks. We do not use derivatives for trading purposes, to generate income or to engage in speculative activity. Our capital costs are directly linked to financial and

business risks. We seek to manage the potential negative effects from market volatility and market risk. The majority of our financial instruments are medium- and long-term fixed rate notes and debentures. Fluctuations in market interest rates can lead to significant fluctuations in the fair value of these notes and debentures. It is our policy to manage our debt structure and foreign exchange exposure in order to manage capital costs, control financial risks and maintain financial flexibility over the long term. Where appropriate, we will take actions to limit the negative effect of interest and foreign exchange rates, liquidity and counterparty risks on stockholder value.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

We enter into foreign currency contracts to minimize our exposure to risk of adverse changes in currency exchange rates. We are subject to foreign exchange risk for foreign currency-denominated transactions, such as debt issued, recognized payables and receivables and forecasted transactions. At December 31, 2007, our foreign currency exposures were principally Euros, British pound sterling, Danish krone and Japanese yen.

### QUANTITATIVE INFORMATION ABOUT MARKET RISK

In order to determine the changes in fair value of our various financial instruments, we use certain financial modeling techniques. We apply rate-sensitivity changes directly to our interest rate swap transactions and forward rate sensitivity to our foreign currency-forward contracts.

The changes in fair value, as discussed below, assume the occurrence of certain market conditions, which could have an adverse financial impact on AT&T and do not represent

projected gains or losses in fair value that we expect to incur. Future impacts would be based on actual developments in global financial markets. We do not foresee any significant changes in the strategies used to manage interest rate risk, foreign currency rate risk or equity price risk in the near future.

**Interest Rate Sensitivity** The principal amounts by expected maturity, average interest rate and fair value of our liabilities that are exposed to interest rate risk are described in Notes 8 and 9. Following are our interest rate derivatives, subject to interest rate risk as of December 31, 2007. The interest rates illustrated in the interest rate swaps section of the table below refer to the average expected rates we would receive and the average expected rates we would pay based on the contracts. The notional amount is the principal amount of the debt subject to the interest rate swap contracts. The net fair value asset (liability) represents the amount we would receive or pay if we had exited the contracts as of December 31, 2007.

|  | Maturity |      |      |         |         |               | Total   | Fair Value<br>12/31/07 |
|--|----------|------|------|---------|---------|---------------|---------|------------------------|
|  | 2008     | 2009 | 2010 | 2011    | 2012    | After<br>2012 |         |                        |
| <b>Interest Rate Derivatives</b>           |          |      |      |         |         |               |         |                        |
| Interest Rate Swaps:                       |          |      |      |         |         |               |         |                        |
| Receive Fixed/Pay Variable Notional Amount | —        | —    | —    | \$1,250 | \$2,000 | —             | \$3,250 | \$88                   |
| Variable Rate Payable <sup>1</sup>         | 4.6%     | 4.4% | 5.1% | 5.4%    | 5.3%    | —             |         |                        |
| Weighted-Average Fixed Rate Receivable     | 6.0%     | 6.0% | 6.0% | 6.0%    | 5.9%    | —             |         |                        |

<sup>1</sup>Interest payable based on current and implied forward rates for Three or Six Month LIBOR plus a spread ranging between approximately 64 and 170 basis points.

We had fair value interest rate swaps with a notional value of \$3,250 at December 31, 2007, and \$5,050 at December 31, 2006, with a net carrying and fair value asset of \$88 and liability of \$80, respectively. The net fair value liability at December 31, 2006, was comprised of a liability of \$86 and an asset of \$6. Included in the fair value interest rate swap notional amount for 2006 were interest rate swaps with a notional value of \$1,800, which were acquired as a result of our acquisition of BellSouth on December 29, 2006. These swaps were unwound in January 2007.

**Foreign Exchange Forward Contracts** The fair value of foreign exchange contracts is subject to changes in foreign currency exchange rates. For the purpose of assessing specific risks, we use a sensitivity analysis to determine the effects that market risk exposures may have on the fair value of our financial instruments and results of operations. To perform the sensitivity analysis, we assess the risk of loss in fair values from the effect of a hypothetical 10% change in the value of foreign currencies (negative change in the value of the U.S. dollar), assuming no change in interest rates. See Note 9 to the consolidated financial statements for additional information relating to notional amounts and fair values of financial instruments.

For foreign exchange forward contracts outstanding at December 31, 2007, assuming a hypothetical 10% depreciation

of the U.S. dollar against foreign currencies from the prevailing foreign currency exchange rates, the fair value of the foreign exchange forward contracts (net liability) would have decreased approximately \$29. Because our foreign exchange contracts are entered into for hedging purposes, we believe that these losses would be largely offset by gains on the underlying transactions.

The risk of loss in fair values of all other financial instruments resulting from a hypothetical 10% change in market prices was not significant as of December 31, 2007.

### QUALITATIVE INFORMATION ABOUT MARKET RISK

**Foreign Exchange Risk** From time to time, we make investments in businesses in foreign countries, are paid dividends and receive proceeds from sales or borrow funds in foreign currency. Before making an investment, or in anticipation of a foreign currency receipt, we often will enter into forward foreign exchange contracts. The contracts are used to provide currency at a fixed rate. Our policy is to measure the risk of adverse currency fluctuations by calculating the potential dollar losses resulting from changes in exchange rates that have a reasonable probability of occurring. We cover the exposure that results from changes that exceed acceptable amounts. We do not speculate in foreign exchange markets.



**Interest Rate Risk** We issue debt in fixed and floating rate instruments. Interest rate swaps are used for the purpose of controlling interest expense by managing the mix of fixed and floating rate debt. Interest rate forward contracts are utilized to hedge interest expense related to debt financing. We do not seek to make a profit from changes in interest rates. We manage interest rate sensitivity by measuring potential increases in interest expense that would result from a probable change in interest rates. When the potential increase in interest expense exceeds an acceptable amount, we reduce risk through the issuance of fixed-rate (in lieu of variable-rate) instruments and the purchase of derivatives.

**Issuer Equity Repurchases**

On March 4, 2006, our Board of Directors authorized the repurchase of up to 400 million shares of AT&T common

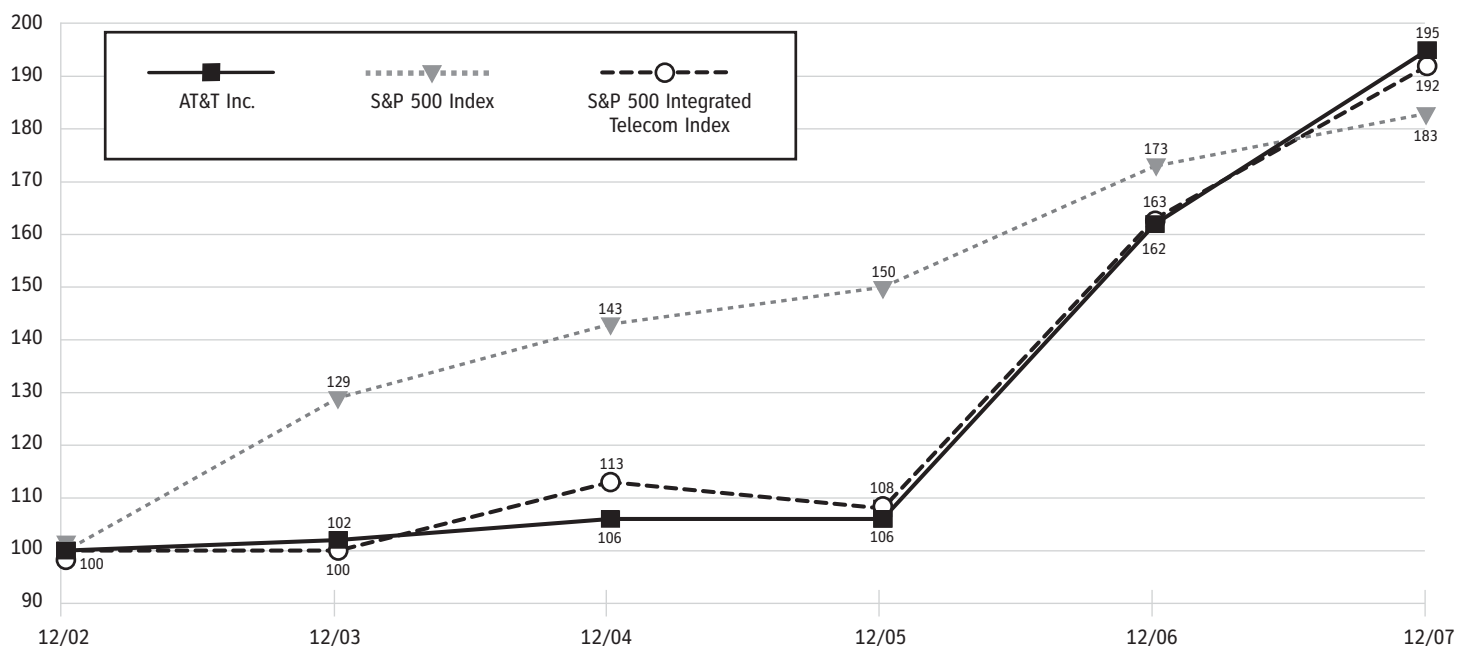
stock. During the fourth quarter of 2007, we repurchased 37 million shares at a cost of \$1,478. Share repurchases under this plan totaled approximately 351 million shares at a cost of \$13,068. On December 10, 2007, our Board of Directors authorized a new share repurchase plan of 400 million shares, which replaces our previous share repurchase authorization. This new authorization represents approximately 6.6% of AT&T's shares outstanding at December 31, 2007 and expires at the end of 2009. We have repurchased, and intend to continue to repurchase, a portion of the shares pursuant to plans that comply with the requirements of Rule 10b5-1(c) under the Securities Exchange Act of 1934. We will fund our share repurchases through a combination of cash from operations, borrowings dependent upon market conditions, and cash from the disposition of certain non-strategic investments.

| Purchase Period                      | Total Number of Shares Purchased | Average Price Paid per Share <sup>1</sup> | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs <sup>2</sup> |
|--------------------------------------|----------------------------------|---|--|---|
| October 1, 2007 – October 31, 2007   | 11,500,000                       | \$41.94                                   | 11,500,000   | 74,708,783  |
| November 1, 2007 – November 30, 2007 | 23,500,000                       | \$39.13                                   | 23,500,000   | 51,208,783  |
| December 3, 2007 – December 5, 2007  | 2,000,000                        | \$37.81                                   | 2,000,000  | 49,208,783  |
| <b>Total</b>                         | <b>37,000,000</b>                | <b>\$39.93</b>                            | <b>37,000,000</b>  | <b>49,208,783</b>   |

<sup>1</sup>Average Price Paid per Share excludes transaction costs.  
<sup>2</sup>Replaced by new authorization on December 10, 2007.

**STOCK PERFORMANCE GRAPH**

Comparison of Five-Year Cumulative Total Return  
 AT&T Inc., S&P 500 Index and S&P 500 Integrated Telecom Index



The comparison above assumes \$100 invested on December 31, 2002, in AT&T common stock, Standard & Poor's 500 Index (S&P 500), and Standard & Poor's 500 Integrated Telecom Index (Telecom Index). Total return equals stock price appreciation plus reinvestment of dividends on a quarterly basis.

### **CERTIFICATION BY THE CHIEF EXECUTIVE OFFICER**

As required under the rules of the New York Stock Exchange (NYSE), our chief executive officer has timely submitted to the NYSE his annual certification that he is not aware of any violation by the company of NYSE corporate governance standards. Also as required under the rules of the NYSE, readers are advised that the certifications required under Section 302 of the Sarbanes-Oxley Act of 2002 are not included in this report but instead are included as exhibits to our Annual Report on Form 10-K for 2007.

### **RISK FACTORS**

In addition to the other information set forth in this document, including the matters contained under the caption "Cautionary Language Concerning Forward-Looking Statements," you should carefully read the matters described below. We believe that each of these matters could materially affect our business. We recognize that most of these factors are beyond our ability to control and therefore to predict an outcome. Accordingly, we have organized them by first addressing general factors, then industry factors and, finally, items specifically applicable to us.

#### **Adverse changes in the U.S. economy could materially hamper our customers' abilities to purchase our products and services.**

We provide services and products to consumers and large and small businesses in the United States and to larger businesses throughout the world. While our wireless customers are located throughout the United States, our wireline consumer and small business customers are located in the 22 states in which we provide local exchange services. Adverse changes in the U.S. economy are likely to adversely affect these customers' ability to pay for existing services and to decrease their interest in purchasing new services. Should this customer pullback occur, we likely would experience both a decrease in revenues and an increase in certain expenses, including expenses relating to bad debt. We are also likely to experience pressure on pricing and margins as we continue to compete for customers who would have less discretionary income. While our large-business customers are less likely to be affected by adverse changes in any particular economy, a lengthy U.S. or a global recession would tend to affect them in a similar manner.

#### **Adverse changes in medical costs and the U.S. securities markets and interest rates could materially increase our benefit plan costs.**

Our pension and postretirement costs are subject to increases, primarily due to continuing increases in medical and prescription drug costs and can be affected by lower returns in prior years on funds held by our pension and other benefit plans, which are reflected in our financial statements over several years. Investment returns on these funds depend largely on trends in the U.S. securities markets and the U.S. economy. In calculating the annual costs included on our financial statements of providing benefits under our plans, we have made certain assumptions regarding future investment returns, medical costs and interest rates. If actual investment returns, medical costs and interest rates are worse than those previously assumed, our annual costs will increase.

The FASB required companies to recognize the funded status of defined benefit pension and postretirement plans as an asset or liability in our statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income. Therefore, an increase in our costs will have a negative effect on our balance sheet.

#### **Changes in available technology could increase competition and our capital costs.**

The telecommunications industry has experienced rapid changes in the last several years. The development of wireless, cable and IP technologies has significantly increased the commercial viability of alternatives to traditional wireline telephone service and enhanced the capabilities of wireless networks. In order to remain competitive, we have begun to deploy a more sophisticated wireline network and continue to deploy a more sophisticated wireless network, as well as research other new technologies. If the new technologies we have adopted or on which we have focused our research efforts fail to be cost-effective and accepted by customers, our ability to remain competitive could be materially adversely affected.

#### **Changes to federal, state and foreign government regulations and decisions in regulatory proceedings could materially adversely affect us.**

Our wireline subsidiaries are subject to significant federal and state regulation while many of our competitors are not. In addition, our subsidiaries and affiliates operating outside the U.S. are also subject to the jurisdiction of national and supranational regulatory authorities in the market where service is provided. Our wireless subsidiaries are regulated to varying degrees by the FCC and some state and local agencies. The adoption of new regulations or changes to existing regulations could significantly increase our costs, which either would reduce our operating margins or potentially increase customer turnover should we attempt to increase prices to cover our increased costs. In addition, the development of new technologies, such as IP-based services, has created or potentially could create conflicting regulation between the FCC and various state and local authorities, which may involve lengthy litigation to resolve and may result in outcomes unfavorable to us.

#### **Increasing competition in our wireline markets could adversely affect wireline operating margins.**

We expect competition in the telecommunications industry to continue to intensify. We expect this competition will continue to put pressure on pricing, margins and customer retention. A number of our competitors that rely on alternative technologies (e.g., wireless, cable and VoIP) are typically subject to less (or no) regulation than our wireline and ATTC subsidiaries and therefore are able to operate with lower costs. These competitors also have cost advantages compared to us, due in part to a nonunionized workforce, lower employee benefits and fewer retirees (as most of the competitors are relatively new companies). We believe such advantages can be offset by continuing to increase the efficiency of our operating systems and by improving employee training and productivity; however, there can be no guarantee that our efforts in these areas will be successful.

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**Increasing competition in the wireless industry could adversely affect our operating results.**

On average, we have three to four other wireless competitors in each of our service areas and compete for customers based principally on price, service offerings, call quality, coverage area and customer service. In addition, we are likely to experience growing competition from providers offering services using alternative wireless technologies and IP-based networks as well as traditional wireline networks. We expect intense industry competition and market saturation may cause the wireless industry's customer growth rate to moderate in comparison with historical growth rates. We expect that the availability of additional 700 MHz spectrum to be licensed through the FCC's ongoing spectrum auction could increase competition, the effectiveness of existing competition, or result in new entrants in the wireless arena. This competition will continue to put pressure on pricing and margins as companies compete for potential customers. Our ability to respond will depend, among other things, on continued improvement in network quality and customer service and effective marketing of attractive products and services, and cost management. These efforts will involve significant expenses and require strategic management decisions on, and timely implementation of equipment choices, marketing plans and financial budgets.

**Equipment failures, natural disasters and terrorist attacks may materially adversely affect our operations.**

Major equipment failures or natural disasters, including severe weather, terrorist acts or other breaches of network or IT security that affect our wireline and wireless networks, including telephone switching offices, microwave links, third-party owned local and long-distance networks on which we rely, our cell sites or other equipment, could have a material adverse effect on our operations. While we have insurance coverage for some of these events, our inability to operate our wireline or wireless systems, even for a limited time period, may result in significant expenses, a loss of customers or impair our ability to attract new customers, which could have a material adverse effect on our business, results of operations and financial condition.

**The success of our U-verse services initiative will depend on the timing, extent and cost of deployment; the development of attractive and profitable service offerings; the extent to which regulatory, franchise fees and build-out requirements apply to this initiative; and the availability and reliability of the various technologies required to provide such offerings.**

The trend in telecommunications technology is to shift from the traditional circuit- and wire-based technology to IP-based technology. IP-based technology can transport voice and data, as well as video, from both wired and wireless networks. IP-based networks also potentially cost less to operate than traditional networks. Our competitors, many of which are newer companies, are deploying this IP-based technology. In order to continue to offer attractive and

competitively priced services, we are deploying a new broadband network to offer IP-based voice, data and video services. Using a new and sophisticated technology on a very large scale entails risks but also presents opportunities to expand service offerings to customers. Should deployment of our network be delayed or costs exceed expected amounts, our margins would be adversely affected and such effects could be material. Should regulatory requirements be different than we anticipated, our deployment could be delayed, perhaps significantly, or limited to only those geographical areas where regulation is not burdensome. In addition, should the delivery of services expected to be deployed on our network be delayed due to technological or regulatory constraints, performance of suppliers, or other reasons, or the cost of providing such services becomes higher than expected, customers may decide to purchase services from our competitors, which would adversely affect our revenues and margins, and such effects could be material.

**The impact of our year-end 2006 acquisition of BellSouth, including the risk that the businesses will not be integrated successfully; the risk that the cost-savings and any other synergies from the acquisition may take longer to realize than expected or may not be fully realized; and disruption from the acquisition may make it more difficult to maintain relationships with customers, employees or suppliers.**

We acquired BellSouth in order to streamline the ownership and operations of AT&T Mobility and to combine the AT&T Mobility, BellSouth and AT&T IP networks into a single IP network; to speed the deployment, and at lower cost, of next-generation IP video and other services; to provide business customers with the benefits of combining AT&T's national and international networks and services with BellSouth's local exchange and broadband services; and to create potential cost-savings, technological development and other benefits. Achieving these results will depend in part on successfully integrating three large corporations, which could involve significant management attention and create uncertainties for employees. To date, this integration has proceeded on schedule and within our budget assumptions. We have not experienced any significant customer or supplier disruptions. However, this process is lengthy and we expect that it will continue to involve significant management attention. We also expect to incur substantial expenses related to the integration of these companies. We must integrate a large number of systems, both operational and administrative. These integration expenses may result in our taking significant charges against earnings, both cash and noncash, primarily from the amortization of intangibles. Delays in this process could have a material adverse effect on our revenues, expenses, operating results and financial condition. In addition, events outside of our control, including changes in state and federal regulation and laws as well as economic trends, also could adversely affect our ability to realize the expected benefits from this acquisition.

## Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Dollars in millions except per share amounts

### CAUTIONARY LANGUAGE CONCERNING FORWARD-LOOKING STATEMENTS

Information set forth in this report contains forward-looking statements that are subject to risks and uncertainties, and actual results could differ materially. Many of these factors are discussed in more detail in the "Risk Factors" section. We claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

The following factors could cause our future results to differ materially from those expressed in the forward-looking statements:

- Adverse economic changes in the markets served by us or in countries in which we have significant investments.
- Changes in available technology and the effects of such changes including product substitutions and deployment costs.
- Increases in our benefit plans' costs including increases due to adverse changes in the U.S. and foreign securities markets, resulting in worse-than-assumed investment returns and discount rates, and adverse medical cost trends.
- The final outcome of Federal Communications Commission proceedings and reopenings of such proceedings and judicial review, if any, of such proceedings, including issues relating to access charges, broadband deployment, unbundled loop and transport elements and wireless services.
- The final outcome of regulatory proceedings in the states in which we operate and reopenings of such proceedings, and judicial review, if any, of such proceedings, including proceedings relating to interconnection terms, access charges, universal service, unbundled network elements and resale and wholesale rates, broadband deployment including our U-verse services, performance measurement plans, service standards and traffic compensation.
- Enactment of additional state, federal and/or foreign regulatory and tax laws and regulations pertaining to our subsidiaries and foreign investments.
- Our ability to absorb revenue losses caused by increasing competition, including offerings using alternative technologies (e.g., cable, wireless and VoIP), and our ability to maintain capital expenditures.
- The extent of competition and the resulting pressure on access line totals and wireline and wireless operating margins.
- Our ability to develop attractive and profitable product/service offerings to offset increasing competition in our wireless and wireline markets.
- The ability of our competitors to offer product/service offerings at lower prices due to lower cost structures and regulatory and legislative actions adverse to us, including state regulatory proceedings relating to unbundled network elements and nonregulation of comparable alternative technologies (e.g., VoIP).
- The timing, extent and cost of deployment of our U-verse services (our Lightspeed initiative); the development of attractive and profitable service offerings; the extent to which regulatory, franchise fees and build-out requirements apply to this initiative; and the availability, cost and/or reliability of the various technologies and/or content required to provide such offerings.
- The outcome of pending or threatened litigation including patent claims by or against third parties.
- The impact on our networks and business of major equipment failures, severe weather conditions, natural disasters or terrorist attacks.
- The issuance by the Financial Accounting Standards Board or other accounting oversight bodies of new accounting standards or changes to existing standards.
- The issuance by the Internal Revenue Service and/or state tax authorities of new tax regulations or changes to existing standards and actions by federal, state or local tax agencies and judicial authorities with respect to applying applicable tax laws and regulations; and the resolution of disputes with any taxing jurisdictions.
- Our ability to adequately fund our wireless operations, including access to additional spectrum; network upgrades and technological advancements.
- The impact of our acquisition of BellSouth, including the risk that the businesses will not be integrated successfully; the risk that the cost savings and any other synergies from the acquisition may take longer to realize than expected or may not be fully realized; and disruption from the acquisition may make it more difficult to maintain relationships with customers, employees or suppliers.
- Changes in our corporate strategies, such as changing network requirements or acquisitions and dispositions, to respond to competition and regulatory, legislative and technological developments.

Readers are cautioned that other factors discussed in this report, although not enumerated here, also could materially affect our future earnings.