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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

**For the quarterly period ended June 30, 2005**

**or**

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

**For the transition period from to**

**Commission File No. 001-03040**

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**QWEST CORPORATION**

(Exact name of registrant as specified in its charter)

**Colorado**

(State or other jurisdiction of  
incorporation or organization)

**84-0273800**

(I.R.S. Employer  
Identification No.)

**1801 California Street, Denver, Colorado**

(Address of principal executive offices)

**80202**

(Zip Code)

**(303) 992-1400**

(Registrant's telephone number, including area code)

**N/A**

(Former name, former address and former fiscal year, if changed since last report)

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THE REGISTRANT, A WHOLLY OWNED SUBSIDIARY OF QWEST COMMUNICATIONS INTERNATIONAL INC., MEETS THE CONDITIONS SET FORTH IN GENERAL INSTRUCTIONS H(1)(a) AND (b) OF FORM 10-Q AND IS THEREFORE FILING THIS FORM WITH REDUCED DISCLOSURE FORMAT PURSUANT TO GENERAL INSTRUCTION H(2).

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

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

On July 31, 2005, one share of Qwest Corporation common stock was outstanding.

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**QWEST CORPORATION**

**FORM 10-Q**

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## GLOSSARY OF TERMS

Our industry uses many terms and acronyms that may not be familiar to you. To assist you in reading this document, we have provided below definitions of some of these terms.

- *Access Lines.* Telephone lines reaching from the customer's premises to a connection with the public switched telephone network. When we refer to our access lines we mean all our mass markets, wholesale and business access lines, including those used by us and our affiliates.
- *Asynchronous Transfer Mode (ATM).* A broadband, network transport service that provides a fast, efficient way to move large quantities of information.
- *Bell Operating Company (BOC).* As defined in the Telecommunications Act of 1996, the term includes Qwest Corporation, as the successor to U S WEST Communications, Inc. Under the Telecommunications Act of 1996, "Bell Operating Company" also would include any successor or assign of Qwest Corporation that provides wireline telephone exchange service.
- *Competitive Local Exchange Carriers (CLECs).* Telecommunications providers that compete with us in providing local voice services in our local service area.
- *Customer Premises Equipment (CPE).* Telecommunications equipment sold to a customer, usually in connection with our providing telecommunications services to that customer.
- *Dedicated Internet Access (DIA).* Internet access ranging from 128 kilobits per second to 2.4 gigabits per second.
- *Digital Subscriber Line (DSL).* A technology for providing high speed data communications over telephone lines.
- *Frame Relay.* A high speed switching technology, primarily used to interconnect multiple local networks.
- *Incumbent Local Exchange Carrier (ILEC).* A traditional telecommunications provider, such as Qwest Corporation, that, prior to the Telecommunications Act of 1996, had the exclusive right and responsibility for providing local telecommunications services in its local service area.
- *Integrated Services Digital Network (ISDN).* A telecommunications standard that uses digital transmission technology to support voice, video and data communications applications over regular telephone lines.
- *Interexchange Carriers (IXCs).* Telecommunications providers that provide long-distance services to end users by handling calls that are made from a phone exchange in one LATA to an exchange in another LATA or between exchanges within a LATA.
- *InterLATA long-distance services.* Telecommunications services, including "800" services, that cross LATA boundaries.
- *Internet Dial Access.* Provides ISPs and business customers with a comprehensive, reliable and cost-effective dial-up network infrastructure.
- *Internet Protocol (IP).* A protocol for transferring information across the Internet in packets of data.
- *Internet Service Providers (ISPs).* Businesses that provide Internet access to retail customers.
- *IntraLATA long-distance services.* These services include calls that terminate outside a caller's local calling area but within their LATA, including wide area telecommunications service or "800" services for customers with geographically highly concentrated demand.

- *Local Access Transport Area (LATA).* A geographical area in which telecommunications providers may offer services. There are 163 LATAs in the United States and 27 in our local service area.
- *Local Calling Area.* A geographical area, usually smaller than a LATA, within which a customer can make telephone calls without incurring long-distance charges. Multiple local calling areas generally make up a LATA.
- *Private Lines.* Direct circuits or channels specifically dedicated to the use of an end-user organization for the purpose of directly connecting two or more sites.
- *Public Switched Telephone Network (PSTN).* The worldwide voice telephone network that is accessible to every person with a telephone and a dial tone.
- *Unbundled Network Elements (UNEs) Platform (UNE-P).* Discrete elements of our network that are sold or leased to competitive telecommunications providers and that may be combined to provide their retail telecommunications services.
- *Virtual Private Network (VPN).* A private network that operates securely within a public network (such as the Internet) by means of encrypting transmissions.
- *Voice over Internet Protocol (VoIP).* An application that provides real-time, two-way voice capability originating in the Internet protocol over a broadband connection.
- *Web Hosting.* The providing of space, power and bandwidth in data centers for hosting of customers' Internet equipment.

# PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

### QWEST CORPORATION

#### CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(DOLLARS IN MILLIONS)

(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Operating revenue	\$ 2,262	\$ 2,338	\$ 4,530	\$ 4,727
Operating revenue—affiliates	280	226	563	455
Total operating revenue	2,542	2,564	5,093	5,182
Operating expenses:				
Cost of sales (exclusive of depreciation and amortization)	524	548	1,057	1,078
Cost of sales—affiliates	65	101	118	170
Selling, general and administrative	423	406	833	855
Selling, general and administrative—affiliates	298	324	598	603
Depreciation	578	584	1,157	1,159
Amortization of capitalized software and other intangible assets	85	95	176	187
Asset impairment charges	—	19	—	19
Total operating expenses	1,973	2,077	3,939	4,071
Operating income	569	487	1,154	1,111
Other expense (income):				
Interest expense—net	151	147	300	294
Loss on early retirement of debt—net	37	—	37	—
Other income—net	(20)	(6)	(7)	(9)
Total other expense—net	168	141	330	285
Income before income taxes, and discontinued operations	401	346	824	826
Income tax expense	(151)	(136)	(312)	(322)
Income from continuing operations	250	210	512	504
Loss from discontinued operations, net of tax benefit of \$0, \$7, \$0, and \$34, respectively	—	(12)	—	(53)
Net income	\$ 250	\$ 198	\$ 512	\$ 451

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

**QWEST CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(DOLLARS IN MILLIONS)**  
**(UNAUDITED)**

	<b>June 30, 2005</b>	<b>December 31, 2004</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 345	\$ 342
Short-term investments	92	206
Accounts receivable (less allowance for doubtful accounts of \$69 million and \$72 million, respectively)	1,051	1,066
Accounts receivable—affiliates	162	156
Prepaid and other assets	320	374
	<hr/>	<hr/>
Total current assets	1,970	2,144
Property, plant and equipment—net	14,554	15,269
Capitalized software and other intangible assets—net	681	798
Prepaid pension asset	1,014	1,021
Other assets	330	358
	<hr/>	<hr/>
Total assets	\$ 18,549	\$ 19,590
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDER'S EQUITY</b>		
Current liabilities:		
Current borrowings	\$ 63	\$ 405
Accounts payable	357	367
Accounts payable—affiliates	470	675
Dividends payable—QSC	67	412
Accrued expenses and other current liabilities	683	803
Deferred revenue and advanced billings	489	511
	<hr/>	<hr/>
Total current liabilities	2,129	3,173
Long-term borrowings (net of unamortized debt discount of \$131 and \$138, respectively)	7,661	7,255
Post-retirement and other post-employment benefit obligations	2,859	2,833
Deferred income taxes	2,286	2,194
Other long-term liabilities	506	531
	<hr/>	<hr/>
Total liabilities	15,441	15,986
	<hr/>	<hr/>
Commitments and contingencies (Note 6)		
Stockholder's equity:		
Common stock—one share without par, owned by QSC	10,144	10,150
Accumulated deficit	(7,036)	(6,546)
	<hr/>	<hr/>
Total stockholder's equity	3,108	3,604
	<hr/>	<hr/>
Total liabilities and stockholder's equity	\$ 18,549	\$ 19,590
	<hr/>	<hr/>

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

**QWEST CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(DOLLARS IN MILLIONS)**  
**(UNAUDITED)**

	Six Months Ended June 30,	
	2005	2004
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 512	\$ 451
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss from discontinued operations, net of tax	—	53
Depreciation and amortization	1,333	1,346
Provision for bad debts	40	3
Asset impairment charges	—	19
Deferred income taxes	122	(98)
Income tax benefit distributed to QSC	—	(32)
Loss on early retirement of debt	37	—
Other non-cash charges—net	11	9
Changes in operating assets and liabilities:		
Accounts receivable	(25)	105
Accounts receivable—affiliates	(6)	72
Prepaid and other current assets	16	27
Accounts payable and accrued expenses	(133)	(219)
Accounts payable—affiliates	(205)	(20)
Deferred revenue and advance billings	(33)	(121)
Other non-current assets and liabilities	42	51
Cash provided by operating activities	1,711	1,646
<b>INVESTING ACTIVITIES</b>		
Expenditures for property, plant and equipment (net of tax refund of \$33 million in 2005)	(517)	(807)
Interest in net proceeds from investments managed by QSC	126	135
Other	13	13
Cash used for investing activities	(378)	(659)
<b>FINANCING ACTIVITIES</b>		
Proceeds from long-term borrowings	1,150	—
Collection on note receivable—affiliate	—	265
Repayments of long-term borrowings, including current maturities	(1,092)	(176)
Dividends paid to QSC	(1,345)	(1,410)
Equity infusion from QSC	—	2,185
Payment of current borrowings—affiliate by Qwest Wireless	—	(2,185)
Debt issuance costs	(18)	—
Other	(25)	—
Cash used for financing activities	(1,330)	(1,321)
<b>CASH AND CASH EQUIVALENTS</b>		
Increase (decrease) in cash and cash equivalents	3	(334)
Net cash generated by discontinued operations	—	1
Beginning balance	342	655
Ending balance	\$ 345	\$ 322

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





# QWEST CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

FOR THE THREE AND SIX MONTHS ENDED JUNE 30, 2005

(UNAUDITED)

*Unless the context requires otherwise, references in this report to "Qwest," "we," "us," the "Company" and "our" refer to Qwest Corporation and its consolidated subsidiaries, and references to "QCII" refer to our ultimate parent company, Qwest Communications International Inc., and its consolidated subsidiaries.*

### **Note 1: Basis of Presentation**

These condensed consolidated interim financial statements are unaudited and are prepared in accordance with the instructions for Form 10-Q. In compliance with those instructions, certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America ("GAAP") have been condensed or omitted.

In the opinion of management, these statements include all the adjustments necessary to fairly present our condensed consolidated results of operations, financial position and cash flows as of June 30, 2005 and for all periods presented. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in our annual report on Form 10-K for the year ended December 31, 2004 (the "2004 Form 10-K"). The condensed consolidated results of operations for the three and six-month periods ended June 30, 2005 and the condensed consolidated statement of cash flows for the six-month period ended June 30, 2005 are not necessarily indicative of the results or cash flows expected for the full year.

Until May 1, 2004, we provided wireless services through our wholly owned subsidiary, Qwest Wireless LLC ("Qwest Wireless"). On May 1, 2004, we transferred ownership of Qwest Wireless to an affiliate. As a consequence, we no longer have wireless operations, and the results of Qwest Wireless are reported as a loss from discontinued operations in our condensed consolidated statements of operations for the three and six months ended June 30, 2004. See Note 2—Transfer of Qwest Wireless Operations, for additional information on the results of Qwest Wireless.

Approximately 60% of QCII's employees are represented by collective bargaining agreements with the Communications Workers of America ("CWA") and the International Brotherhood of Electrical Workers ("IBEW"). In August 2003, we entered into two-year collective bargaining agreements with the CWA and IBEW and each of these agreements expires on August 13, 2005.

### ***Use of estimates***

Our consolidated financial statements are prepared in accordance with GAAP. These accounting principles require us to make certain estimates, judgments and assumptions. We believe that the estimates, judgments and assumptions made when accounting for items and matters such as long-term contracts, customer retention patterns, allowance for bad debts, depreciation, amortization, asset valuations, internal labor capitalization rates, recoverability of assets, impairment assessments, employee benefits, taxes, reserves and other provisions and contingencies are reasonable, based on information available at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. We also assess potential losses in relation to threatened or pending litigation and, if a loss is considered probable and the amount can be reasonably estimated, we recognize an expense for the estimated loss. Actual results could differ from these estimates. See Note 6—Commitments and Contingencies.

### ***Combined pension and post-retirement benefits***

Our employees participate in the QCII pension and other post-employment benefit plans. We refer to the combined pension and post-retirement benefits costs as net pension expense.

### ***Depreciation***

Property, plant and equipment are shown net of depreciation on our balance sheet. As of June 30, 2005 and December 31, 2004 accumulated depreciation was \$28.5 billion and \$27.6 billion, respectively.

### ***Stock-based compensation***

Some of our employees participate in QCII's stock option plans. These plans are accounted for using the intrinsic-value recognition and measurement principles of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Under the intrinsic value method no compensation expense is recognized for options granted to employees when the strike price of those options equals or exceeds the value of the underlying security on the measurement date. Any excess of the stock price on the measurement date over the exercise price is recorded as deferred compensation and amortized over the service period during which the stock option award vests using the accelerated method described in Financial Accounting Standards Board ("FASB") Interpretation ("FIN") No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans." QCII allocates to us, through a contribution, our share of the deferred compensation expense described herein based on options granted to our employees.

Had compensation cost for our employees' participation in the QCII stock-based compensation plans been determined under the fair-value method in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," our net income would have been changed to the pro forma amounts indicated below:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(Dollars in millions)			
Net Income:				
As reported	\$ 250	\$ 198	\$ 512	\$ 451
Remove: Stock-based employee compensation included in net income, net of related tax effects	(1)	(2)	(1)	(1)
Include: Total stock-based employee compensation expense determined under the fair-value-based method for all awards, net of related tax effects	(6)	(5)	(12)	(10)
Pro forma net income	\$ 243	\$ 191	\$ 499	\$ 440

The pro forma amounts reflected above may not be representative of the effects on our reported net income or loss in future years because the number of future shares to be issued under these plans is not known and the assumptions used to determine the fair value can vary significantly. See "Recently Issued Accounting Pronouncements" below for further discussion of SFAS No. 123R.

### ***Reclassifications***

We utilize the cash management services of Qwest Services Corporation, our direct parent ("QSC"). QSC concentrates our cash with that of all other QSC subsidiaries and manages and invests the cash on our behalf. We previously reported as cash and cash equivalents on our balance sheets the

amount of cash held by QSC on our behalf for cash management. QSC's cash management portfolio includes cash, money market funds, commercial paper, investments in auction rate securities and U.S. government agency and corporate notes. In March 2005, QCII reclassified its investment in auction rate securities from cash and cash equivalents into short-term investments in its consolidated balance sheets. Following QCII's reclassification of these investments, we decided that our proportionate share of the QSC portfolio of invested cash and our agency relationship with QSC is more appropriately reflected by reclassifying out of cash and cash equivalents into short-term and long-term investments our proportionate share of the investment in auction rate securities and U.S. government agency and corporate notes. Accordingly, we have reclassified \$218 million of cash and cash equivalents as of December 31, 2004 into \$206 million of short-term investments and \$12 million of other non-current assets in our condensed consolidated balance sheets. We have reclassified our interest in the investments managed by our parent in our condensed consolidated statements of cash flows, decreasing cash used for investing activities by \$135 million from \$794 million to \$659 million for the six months ended June 30, 2004. This reclassification has no impact on previously reported total assets or results of operations or on our debt covenants and it does not affect previously reported cash flows from operating or financing activities.

Certain other prior period balances have been reclassified to conform to the current presentation.

### ***Recently issued accounting pronouncements***

In July 2005, the FASB issued an exposure draft of its proposed interpretation intended to clarify the accounting for uncertain tax positions. The interpretation's proposed effective date for us would be December 31, 2005. Until the final interpretation is issued, we are unable to estimate the ultimate impact on our financial statements. However, if the interpretation is issued in its current form, it could result in a significant cumulative charge upon adoption.

In May 2005, the FASB, as part of an effort to conform to international accounting standards, issued SFAS No. 154, "Accounting Changes and Error Corrections," which is effective for us beginning on January 1, 2006. SFAS No. 154 requires that all voluntary changes in accounting principles are retrospectively applied to prior financial statements as if that principle had always been used, unless it is impracticable to do so. When it is impracticable to calculate the effects on all prior periods, SFAS No. 154 requires that the new principle be applied to the earliest period practicable. The adoption of SFAS No. 154 is not anticipated to have a material effect on our financial position or results of operations.

In April 2005, the Securities and Exchange Commission ("SEC") delayed the effective date of SFAS No. 123R, "Share-Based Payments." SFAS No. 123R will now be effective for Qwest as of the interim reporting period beginning January 1, 2006. SFAS No. 123R requires that compensation cost relating to share-based payment transactions be recognized in the financial statements based on the fair value of the equity or liability instruments issued. SFAS No. 123R covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. We do not anticipate that the adoption of SFAS No. 123R will have a material impact on our financial position or results of operations.

In March 2005, the FASB issued FIN 47, "Accounting for Conditional Asset Retirement Obligations." FIN 47 will be effective for Qwest on December 31, 2005 and requires us to recognize asset retirement obligations that are conditional on a future event, such as the obligation to safely dispose of asbestos when a building is remodeled. Uncertainty about the timing or settlement of the obligation is factored into the measurement of the liability. We are in the process of quantifying the impact FIN 47 will have on our financial position and results of operations.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Non-Monetary Assets" which is effective for us starting July 1, 2005. In the past, we were required to measure the value of assets

exchanged in non-monetary transactions by using the net book value of the asset relinquished. Under SFAS No. 153, we will measure assets exchanged at fair value, as long as the transaction has commercial substance and the fair value of the assets exchanged is determinable within reasonable limits. A non-monetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The adoption of SFAS No. 153 is not anticipated to have a material effect on our financial position or results of operations.

### ***Cash and cash equivalents, short-term investments and long-term investments***

As noted above, we utilize the cash management services of QSC. QSC concentrates our cash with that of all other QSC subsidiaries and manages and invests the cash on our behalf in accordance with its cash investment policy. The policy restricts investments to ensure preservation of principal and maintenance of liquidity. The cash balances we report on our balance sheets represent our portion of the QSC portfolio of invested cash.

We consider cash on hand, deposits in banks and investments purchased with original maturities of three months or less to be cash and cash equivalents. Although cash and cash equivalents balances are generally unsecured, our balances are maintained with financial institutions that QSC and we believe are creditworthy. QSC's cash investment policy limits the concentration of investments with specific financial institutions or among certain products and includes criteria related to credit worthiness of any particular financial institution.

The QSC portfolio of short-term investments has historically consisted primarily of auction rate securities. Auction rate securities are highly liquid, variable-rate debt securities. While the underlying security has a stated maturity of typically 20 to 30 years, the interest rate is reset through dutch auctions that are typically held every 7, 28 or 35 days, creating a highly liquid, short-term instrument. The securities trade at par and are callable at par on any interest payment date at the option of the issuer. Interest is paid at the end of each auction period. The QSC portfolio of short-term investments also includes U.S. government agency notes and corporate notes with current maturities of less than twelve months.

The QSC portfolio of long-term investments consists of U.S. government agency notes and corporate notes with current maturities greater than twelve months, but less than twenty-four months.

### **Note 2: Transfer of Qwest Wireless Operations**

On May 1, 2004, we transferred ownership of Qwest Wireless to an affiliate. The transfer was made in the form of a dividend to QSC, and, as a result, no consideration was exchanged. Due to this transfer, we no longer have wireless operations, and the results of Qwest Wireless operations are presented as discontinued operations in these financial statements. Qwest Wireless purchases services from us that previously were eliminated in our consolidation. Revenues related to these services are reflected in our consolidated statements of operations.

The following table presents the summarized results of operations related to our discontinued operations for the three and six months ended June 30, 2004:

	Three Months Ended	Six Months Ended
	June 30, 2004	
	(Dollars in millions)	
Revenue:		
Wireless operating revenue	\$ 42	\$ 168
Qwest revenue from affiliate wireless operations	(10)	(43)
Total revenue	32	125
Costs and expenses:		
Costs of sales	19	64
Selling, general and administrative	18	88
Depreciation and amortization	1	7
Loss from operations	(6)	(34)
Other expense-net	(13)	(53)
Loss before income taxes	(19)	(87)
Income tax benefit	7	34
Loss from discontinued operations	\$ (12)	\$ (53)

### Note 3: Borrowings

As of June 30, 2005 and December 31, 2004, our borrowings, net of discounts and premiums, consisted of the following:

	June 30, 2005	December 31, 2004
	(Dollars in millions)	
Current borrowings:		
Current portion of long-term borrowings	\$ 61	\$ 400
Current portion of capital lease obligations	2	5
Total current borrowings	\$ 63	\$ 405
Long-term borrowings:		
Long-term notes	\$ 7,656	\$ 7,250
Long-term capital lease obligations and real estate notes	5	5
Total long-term borrowings	\$ 7,661	\$ 7,255

### Borrowing Activity

On June 17, 2005, Qwest Corporation ("QC") issued a total of \$1,150 million in notes which consisted of \$750 million in floating rate notes due in 2013 with interest at LIBOR plus 3.25% (6.67% for the current payment period) and \$400 million notes due in 2015 bearing fixed interest at 7.625% per annum. The notes are unsecured general obligations and will rank equally with all of QC's other unsecured and unsubordinated indebtedness. The covenant and default terms are substantially the same as those associated with QC's other long-term debt. QC plans to file an exchange offer registration statement for a new issue of substantially identical notes within 315 calendar days of the date of issuance of the notes. If the exchange offer registration statement does not become effective within 315 calendar days of the issuance of the notes or the exchange offer is not consummated within 45 days of the registration statement's effectiveness date, the rate at which cash interest accrues will increase by 0.25% per annum. The aggregate net proceeds from the offering have been or will be used to fund investments in telecommunication assets, repay indebtedness and, to a limited extent, for other general corporate purposes.



### ***Repayment Activity***

On June 7, 2005, QC announced cash tender offers for the purchase of up to \$250 million of aggregate principal amount of QC's 6.625% notes due September 15, 2005 (the "QC 6.625% Notes"), and up to \$150 million of aggregate principal amount of QC's 6.125% notes due November 15, 2005 (the "QC 6.125% Notes"). QC received and accepted tenders of approximately \$211 million face amount of QC 6.625% Notes for \$216 million, including accrued interest of \$4 million, and approximately \$129 million face amount of QC 6.125% Notes for \$131 million, including accrued interest of \$1 million. Also on June 20 and June 23, 2005 QC pre-paid an aggregate of \$750 million face amount of its \$1.25 billion term loan maturing in June 2007 for \$775 million, including accrued interest of \$2 million. These transactions resulted in a loss of \$37 million due to call and prepayment premiums that ranged from 0.680% to 3.000%.

### ***Exchange Activity***

On May 27, 2005, QC announced registered exchange offers for its 7.875% notes due 2011 (the "2011 QC Notes") and its 8.875% notes due 2012 (the "2012 QC Notes") pursuant to the registration rights agreements that QC entered into in connection with the issuance of these outstanding notes. The terms of the registered 2011 QC Notes and 2012 QC Notes issued in the exchange offers are substantially identical to the terms of the outstanding 2011 QC Notes and 2012 QC Notes, respectively, except that the transfer restrictions, registration rights and additional interest provisions relating to the outstanding notes do not apply to the registered notes. QC completed the registered exchange offers for the 2011 QC Notes and 2012 QC Notes on July 5, 2005.

### ***Interest Rate Swap Activity***

In 2004 we entered into interest rate swap agreements with notational amounts totaling \$575 million. We previously disclosed that these interest rate swap agreements were designated as fair-value hedges, which effectively converted the related fixed-rate debt to floating rate through the receipt of fixed-rate amounts in exchange for floating-rate interest payments. While the structure of the swaps did not change, we determined in the quarter ended March 31, 2005 that these agreements did not meet all the requirements to be treated as fair-value hedges. As a result of this change, the changes in the fair value of the swap agreements were included in other expense (income) in our condensed consolidated results of operations. Had we applied this same accounting treatment to the swap agreements in 2004, the impact would have been less than \$1 million in our 2004 financial statements.

In the quarter ended June 30, 2005, we terminated each of these interest rate swap agreements and paid \$3 million to terminate the agreements. The changes in fair value prior to termination resulted in a net \$13 million non-operating gain for the three months ended June 30, 2005 and a net \$3 million non-operating loss for the six months ended June 30, 2005, respectively, which amounts are included in other expense—net in our condensed consolidated results of operations.

### **Note 4: Restructuring Charges**

The restructuring reserve balances discussed below are included in our condensed consolidated balance sheets in accrued expenses and other current liabilities for the current portion and other long-term liabilities for the long-term portion. As of June 30, 2005 and December 31, 2004, the amounts included as current liabilities were \$29 million and \$49 million, respectively, and the long-term portions were \$11 million and \$12 million, respectively.



An analysis of activity associated with the existing restructuring reserves for the six months ended June 30, 2005 is as follows:

	2004 Restructuring Plan	2003 and Prior Restructuring Plans	Totals
	(Dollars in millions)		
Balance at December 31, 2004	\$ 37	\$ 24	\$ 61
Provisions	—	—	—
Utilizations	(13)	(3)	(16)
Reversals	—	(5)	(5)
Balance at June 30, 2005	\$ 24	\$ 16	\$ 40

We, as part of QCII's 2004 and prior restructuring plans identified specific employee reductions in various functional areas to balance our workload with business demands. As of June 30, 2005, approximately 1,946 of the 2,090 planned employee reductions associated with QCII's 2004 employee reductions had been completed. During the six months ended June 30, 2005, we utilized \$13 million of the 2004 restructuring reserves for severance payments pursuant to established severance policies.

In prior periods, as a part of the 2003 and prior restructuring plans, we permanently abandoned 25 leased facilities with lease terms up to five years and planned employee reductions. The 1,600 planned employee reductions under QCII's 2003 restructuring plan are complete. We anticipate using the balance of the 2003 reserve and prior reserve balances primarily for on-going outplacement services and remaining lease payments provided by the plans.

#### Note 5: Contributions to QCII Segments and Revenue Information

Our operations are integrated into and are part of the segments of the QCII consolidated group. The chief operating decision maker ("CODM") for QCII makes resource allocation decisions and assessments of financial performance for the consolidated group based on wireline, wireless and other segmentation. For more information about QCII's reporting segments, see QCII's annual report on Form 10-K for the year ended December 31, 2004. Our business contributes to the segments reported by QCII, but the QCII CODM reviews our financial information only in connection with our quarterly and annual reports that we file with the SEC. Consequently, we do not provide our discrete financial information to the CODM on a regular basis.

Due to the May 1, 2004 transfer of our wireless operations to one of our affiliates, we no longer include wireless revenue and expenses in our continuing operations. Wireless revenue and expense are included in our discontinued operations. See Note 2—Transfer of Qwest Wireless Operations. Following the transfer of the wireless operations, essentially all of our operations contribute to QCII's wireline services segment. As such, we no longer report our contribution to QCII's segments, as this information does not differ materially from our consolidated statements of operations. However, we continue to provide the following enterprise-wide information on revenues from external customers for each group of similar products and services.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
	(Dollars in millions)			
Voice services	\$ 1,722	\$ 1,795	\$ 3,430	\$ 3,645
Data and Internet services	538	541	1,093	1,073
Other services	2	2	7	9
Total operating revenue	\$ 2,262	\$ 2,338	\$ 4,530	\$ 4,727

Voice services revenue includes local voice services, IntraLATA long-distance voice services and access services. Local voice services revenue includes revenue from basic local exchange services,

switching services, custom calling features, enhanced voice services, operator services, collocation services and CPE. Local voice services revenue also includes revenue from the provision of, on a wholesale basis, network transport, billing services and access to our local network. IntraLATA long-distance voice services revenue includes revenue from IntraLATA long-distance voice services within our local service area. Access services revenue includes fees charged to other long-distance providers to connect to our network.

Data and Internet services revenue includes data services (such as traditional private lines, wholesale private lines, frame relay, integrated services digital network, asynchronous transfer mode and related CPE) and Internet services (such as DSL, Internet dial access and related CPE.)

#### **Note 6: Commitments and Contingencies**

QCII is involved in several legal proceedings to which we are not a party that, if resolved against QCII, could have a material adverse effect on our business and financial condition. We have included below a discussion of these matters, together with a discussion of those matters to which we are a party (primarily those discussed below under the "Regulatory Matters" subheading, as well as the "Colorado action" described below). Only those matters to which we are a party represent contingencies for which we have recorded, or could reasonably anticipate recording, an accrual.

Throughout this note, when we refer to a class action as "putative" it is because a class has been alleged, but not certified in that matter. Until and unless a class has been certified by the court, it has not been established that the named plaintiffs represent the class of plaintiffs they purport to represent.

#### **DOJ Investigation and Securities Actions**

The Department of Justice ("DOJ") investigation and the securities actions described below present material and significant risks to QCII. The size, scope and nature of the restatements of QCII's consolidated financial statements for 2001 and 2000, which are described in QCII's previously issued consolidated financial statements for the year ended December 31, 2002 ("QCII's 2002 Financial Statements"), affect the risks presented by this investigation and these actions, as these matters involve, among other things, QCII's prior accounting practices and related disclosures. Plaintiffs in certain of the securities actions have alleged QCII's restatement of items in support of their claims. We can give no assurance as to the impacts on our and QCII's financial results or financial condition that may ultimately result from all of these matters. During 2003 and 2004, QCII recorded reserves in its financial statements totaling \$750 million in connection with these matters. On October 21, 2004, QCII entered into a settlement with the SEC concluding a formal investigation concerning QCII's accounting and disclosures, among other subjects, that began in April 2002. The \$750 million reserve was reduced by \$125 million in December 2004 as a result of a payment in that amount in connection with QCII's SEC settlement. The remaining reserve amount represents a final payment to be made in connection with the SEC settlement in the amount of \$125 million and the minimum estimated amount of loss QCII believes is probable with respect to the securities actions described below.

QCII has recorded its estimate of the minimum liability because no estimate of probable loss for these matters is a better estimate than any other amount. If the recorded reserve that will remain after QCII has paid the amount owed under the SEC settlement is insufficient to cover these other matters, QCII will need to record additional charges to its statement of operations in future periods. Additionally, QCII is unable at this time to provide a reasonable estimate of the upper end of the range of loss associated with these remaining matters due to their preliminary and complex nature, and, as a result, the amount QCII has reserved for these matters is its estimate of the lowest end of the possible range of loss. The ultimate outcomes of these matters are still uncertain and there is a significant possibility that the amount of loss QCII may ultimately incur could be substantially more than the reserve it has provided.

At this time, QCII believes that it is probable that a portion of the recorded reserve for the securities actions will be recoverable from a portion of the insurance proceeds that were placed in a trust to cover its losses and the losses of individual insureds following its November 12, 2003 settlement of disputes with certain of its insurance carriers related to, among other things, the investigation and securities actions described below. The insurance proceeds are subject to claims by QCII and other insureds for, among other things, the costs of defending certain matters and, as a result, such proceeds are being depleted over time. In any event, the terms and conditions of applicable bylaws, certificates or articles of incorporation, or agreements or applicable laws may obligate QCII or us to indemnify its or our current and former directors, officers and employees with respect to certain liabilities, and QCII and we have been advancing legal fees and costs to many current and former directors, officers and employees in connection with the DOJ investigation, securities actions and certain other matters.

QCII continues to defend against the securities actions vigorously and is currently unable to provide any estimate as to the timing of the resolution of these actions. Any settlement of or judgment in one or more of these actions substantially in excess of QCII's recorded reserves could have a significant impact on QCII, and QCII can give no assurance that it will have the resources available to pay any such judgment. The magnitude of any settlement or judgment resulting from these actions could materially and adversely affect QCII's ability to meet its debt obligations and its financial condition, potentially impacting its credit ratings, its ability to access capital markets and its compliance with debt covenants. In addition, the magnitude of any such settlement or judgment may cause QCII to draw down significantly on its cash balances, which might force QCII to obtain additional financing or explore other methods to generate cash. Such methods could include issuing additional securities or selling assets. As a wholly owned subsidiary of QCII, our business operations and financial condition would be similarly affected.

### **DOJ Investigation**

On July 9, 2002, QCII was informed by the U.S. Attorney's Office for the District of Colorado of a criminal investigation of QCII's business. QCII believes the U.S. Attorney's Office is investigating various matters that include the transactions related to the various adjustments and restatements described in QCII's 2002 Financial Statements, transactions between QCII and certain of its vendors and certain investments in the securities of those vendors by individuals associated with QCII, and certain prior disclosures made by QCII. QCII is continuing in its efforts to cooperate fully with the U.S. Attorney's Office in its investigation. However, QCII cannot predict the outcome of this investigation or the timing of its resolution.

### **Securities Actions**

QCII is a defendant in the securities actions described below. Plaintiffs in these actions have variously alleged, among other things, that QCII violated federal and state securities laws, engaged in fraud, civil conspiracy and negligent misrepresentation, and breached fiduciary duties owed to investors and current and former employees. Other defendants in one or more of these actions include current

and former directors of QCII, former officers and employees of QCII, Arthur Andersen LLP, certain investment banks and others.

- **Consolidated securities action.** Twelve putative class actions purportedly brought on behalf of purchasers of publicly traded securities of QCII between May 24, 1999 and February 14, 2002 have been consolidated into a consolidated securities action pending in federal district court in Colorado. The first of these actions was filed on July 27, 2001. Plaintiffs allege, among other things, that defendants issued false and misleading financial results and made false statements about QCII's business and investments, including making materially false statements in certain QCII registration statements. The most recent complaint in this matter seeks unspecified compensatory damages and other relief. However, counsel for plaintiffs has indicated that the putative class will seek damages in the tens of billions of dollars. Further, a non-class action brought by Stichting Pensioenfonds ABP ("SPA") (described below under "SPA action") has also been consolidated with the consolidated securities action.
- **ERISA actions.** Seven putative class actions purportedly brought on behalf of all participants and beneficiaries of the Qwest Savings and Investment Plan and predecessor plans, or the Plan, from March 7, 1999 until January 12, 2004 have been consolidated into a consolidated action in federal district court in Colorado. These suits also purport to seek relief on behalf of the Plan. The first of these actions was filed in March 2002. Plaintiffs assert breach of fiduciary duty claims against QCII and others under the Employee Retirement Income Security Act of 1974, as amended, alleging, among other things, various improprieties in managing holdings of QCII stock in the Plan. Plaintiffs seek damages, equitable and declaratory relief, along with attorneys' fees and costs and restitution. A non-class action alleging similar claims was filed in the federal district court in Montana in June 2003 and was later transferred to federal district court in Colorado.
- **Colorado action.** A putative class action purportedly brought on behalf of purchasers of QCII's stock between June 28, 2000 and June 27, 2002 and owners of U S WEST stock on June 28, 2000 is pending in Colorado in the District Court for the County of Boulder. We are also a defendant in this action. This action was filed on June 27, 2002. Plaintiffs allege, among other things, that the defendants issued false and misleading statements and engaged in improper accounting practices in order to accomplish the U S WEST/Qwest merger, to make QCII appear successful and to inflate the value of QCII's stock. Plaintiffs seek unspecified monetary damages, disgorgement of illegal gains and other relief.
- **New Jersey action.** An action by the State of New Jersey (Treasury Department, Division of Investment), or New Jersey, is pending in the New Jersey Superior Court, Mercer County. This action was filed on November 27, 2002. New Jersey alleges, among other things, that defendants caused QCII's stock to trade at artificially inflated prices by employing improper accounting practices and by issuing false statements about QCII's business, revenues and profits, and contends that it incurred hundreds of millions of dollars in losses. Among other requested relief, New Jersey seeks from the defendants, jointly and severally, compensatory, consequential, incidental and punitive damages.
- **CalSTRS action.** An action by the California State Teachers' Retirement System, or CalSTRS, is pending in the Superior Court of the State of California in and for the County of San Francisco. This action was filed on December 10, 2002. CalSTRS alleges, among other things, that defendants engaged in a scheme to falsely inflate QCII's revenue and decrease its expenses so that QCII would appear more successful than it actually was during the period in which CalSTRS purchased QCII securities, and asserts that defendants' actions caused it to lose in excess of \$150 million invested in QCII's equity and debt securities. Plaintiffs seek compensatory, special and punitive damages, restitution, pre-judgment interest and costs.

- **SURSI action.** An action by the State Universities Retirement System of Illinois, or SURSI, is pending in the Circuit Court of Cook County, Illinois. This action was filed on January 10, 2003. SURSI alleges, among other things, that defendants engaged in a scheme to falsely inflate QCII's revenues and decrease its expenses by improper conduct related to transactions with various customers and suppliers and claims that its losses from investments in QCII securities are in excess of \$12.5 million. SURSI seeks, among other things compensatory and punitive damages, costs, equitable relief, including an injunction to freeze or prevent disposition of the defendants' assets, and disgorgement.
- **SPA action.** An action by SPA is pending in federal district court in Colorado. This action was filed on February 9, 2004. SPA alleges, among other things, that defendants created a false perception of QCII's revenues and growth prospects and that its losses from investments in QCII securities are in excess of \$100 million. SPA seeks, among other things, compensatory and punitive damages, rescission or rescissionary damages, pre-judgment interest, attorneys' fees and costs.
- **SHC action.** An action by Shriners Hospital for Children, or SHC, is pending in federal district court in Colorado. This action was filed on March 22, 2004. SHC alleges, among other things, that defendants issued false and misleading financial reports about QCII. SHC alleges compensatory damages of approximately \$17 million. SHC seeks compensatory and punitive damages, interest, costs and attorneys' fees.
- **TRSL action.** An action by the Teachers' Retirement System of Louisiana, or TRSL, is pending in federal district court in Colorado. This action was filed on or about March 30, 2004. TRSL alleges, among other things, that defendants issued false and misleading financial reports about QCII. TRSL alleges compensatory damages of approximately \$23 million. TRSL seeks compensatory and punitive damages, interest, costs and attorneys' fees.
- **NYC Funds action.** An action by a number of New York City pension and retirement funds, or NYC Funds, is pending in federal district court in Colorado. This action was filed on September 22, 2004. NYC Funds allege, among other things, that defendants created a false perception of QCII's revenues and growth prospects and that their losses from investments in QCII securities are in excess of \$300 million. NYC Funds seek, among other things, compensatory and punitive damages, rescission or rescissionary damages, pre-judgment interest, attorneys' fees and costs.

### **KPNQwest Litigation**

A putative class action is pending in the federal district court for the Southern District of New York against QCII, certain of its former executives who were also on the supervisory board of KPNQwest (in which QCII was a major shareholder), and others. This lawsuit was initially filed on October 4, 2002. The current complaint alleges, on behalf of certain purchasers of KPNQwest securities, that, among other things, defendants engaged in a fraudulent scheme and deceptive course of business in order to inflate KPNQwest's revenue and the value of KPNQwest securities. Plaintiffs seek compensatory damages and/or rescission as appropriate against defendants, as well as an award of plaintiffs' attorneys' fees and costs.

On October 31, 2002, Richard and Marcia Grand, co-trustees of the R.M. Grand Revocable Living Trust, dated January 25, 1991, filed a lawsuit in Arizona Superior Court which, as amended, alleges, among other things, that the defendants violated state and federal securities laws and breached their fiduciary duty in connection with investments by plaintiffs in securities of KPNQwest. QCII is a defendant in this lawsuit along with Qwest B.V. (a subsidiary of QCII), Joseph Nacchio, QCII's former Chairman and Chief Executive Officer, and John McMaster, the former President and Chief Executive

Officer of KPNQwest. Plaintiffs claim to have lost approximately \$10 million in their investments in KPNQwest.

On June 25, 2004, J.C. van Apeldoorn and E.T. Meijer, in their capacities as trustees in the Dutch bankruptcy proceeding for KPNQwest, filed a complaint in the federal district court for the District of New Jersey alleging violations of the Racketeer Influenced and Corrupt Organizations Act, and breach of fiduciary duty and mismanagement under Dutch law. QCII is a defendant in this lawsuit along with Joseph Nacchio, Robert S. Woodruff, QCII's former Chief Financial Officer, and John McMaster. Plaintiffs allege, among other things, that defendants' actions were a cause of the bankruptcy of KPNQwest and the bankruptcy deficit of KPNQwest was in excess of \$3 billion. Plaintiffs seek compensatory and punitive damages, as well as an award of plaintiffs' attorneys' fees and costs.

On June 17, 2005, Appaloosa Investment Limited Partnership I, Palomino Fund Ltd., and Appaloosa Management L.P. filed a complaint in the federal district court for the Southern District of New York against QCII, Joseph Nacchio, John McMaster and Koninklijke KPN N.V. ("KPN"). The complaint alleges that defendants violated federal securities laws in connection with the purchase by plaintiffs of certain KPNQwest debt securities. Plaintiffs seek compensatory damages, as well as an award of plaintiffs' attorneys' fees and costs.

Various former lenders to KPNQwest or their assignees, including Citibank, N.A., Deutsche Bank AG London and others have notified QCII of their intent to file legal claims in connection with the origination of a credit facility and subsequent borrowings made by KPNQwest of approximately €300 million under that facility. They have indicated that QCII would be a defendant in this threatened lawsuit along with Joseph Nacchio, John McMaster, Drake Tempest, QCII's former General Counsel, KPN and other former employees of QCII, KPN or KPNQwest.

The four KPNQwest litigation matters described above are in preliminary phases and QCII will defend against the four filed cases vigorously and will likewise defend against the fifth matter if it is filed. QCII has not yet conducted discovery on plaintiffs' possible recoverable damages and other relevant issues. Thus, QCII is unable at this time to estimate reasonably a range of loss that it would incur if the plaintiffs in one or more of these matters were to prevail. Any settlement or judgment in certain of these matters could be significant, and QCII can give no assurance that it will have the resources available to pay any such judgment. In the event of an adverse outcome in certain of these matters, QCII's financial condition and its ability to meet its debt obligations could be materially and adversely affected. As a wholly owned subsidiary of QCII, our business operations and financial condition would be similarly affected.

## Regulatory Matters

As described below, formal proceedings against us have been initiated with the public utilities commissions in several states alleging, among other things, that we, in contravention of federal and state law, failed to file interconnection agreements with the state commissions and that we therefore allegedly discriminated against various CLECs. The complainants seek fines, penalties and/or carrier credits.

- **Minnesota.** On February 14, 2002, the Minnesota Department of Commerce filed a formal complaint against us with the Minnesota Public Utilities Commission. On November 1, 2002, the Minnesota Commission issued a written order finding against us. The Minnesota Commission's final, written decision was issued on May 21, 2003 and would require a penalty payment to the state of approximately \$26 million and payments of carrier credits of approximately \$18 million. Of the \$18 million, about \$3 million has been released by the carriers in bankruptcy proceedings. The Minnesota Commission, the carriers and Qwest each appealed portions of the decision to the federal district court in Minnesota, and the district court upheld the penalty and vacated the

carrier credits. The Minnesota Commission, the carriers and Qwest each have appealed to the Eighth Circuit Court of Appeals.

- **Colorado.** On April 15, 2004, Qwest and the Office of Consumer Counsel for Colorado entered into a settlement, subject to Colorado Commission approval, that would require Qwest to pay \$7.5 million in contributions to state telecommunications programs and that offers CLECs credits that could total approximately \$9 million. Of the \$9 million, about \$2 million has been released by the carriers in bankruptcy proceedings. The administrative law judge recommended rejection of the settlement and the initiation of a show cause docket against Qwest. The administrative law judge's recommendation came before the Commission on motions for reconsideration, and on April 25, 2005 the Commission issued an order stating that it will not open a show cause proceeding at this time but rather will open a new proceeding to consider the proposed settlement. Hearings on the proposed settlement are scheduled for September 2005.
- **New Mexico.** In December 2004, Qwest, the New Mexico Staff, the New Mexico Attorney General and party-CLECs entered into and filed for approval a settlement that would resolve all claims for penalties and credits for a total payment of \$3.5 million. On June 30, 2005, the Commission approved the settlement.
- **Oregon.** On June 17, 2005, the Oregon Commission approved a stipulation between Qwest and the Oregon Staff for the payment of a penalty of approximately \$1 million.

Also, some telecommunications providers have filed private actions based on facts similar to those underlying these administrative proceedings. These private actions, together with any similar, future actions, could result in additional damages and awards that could be significant.

On July 15, 2004, the New Mexico state regulatory commission opened a proceeding to investigate whether we are in compliance with or are likely to meet a commitment that we made in 2001 to invest in communications infrastructure in New Mexico through March of 2006 pursuant to an Alternative Form of Regulation plan ("AFOR"). The AFOR says, in part, that "Qwest commits to devote a substantial budget to infrastructure investment, with the goal of achieving the purposes of this Plan. Specifically, Qwest will make capital expenditures of not less than \$788 million over the term of this Plan. This level of investment is necessary to meet the commitments made in this Plan to increase Qwest's investment and improve its service quality in New Mexico." Multiple parties filed comments in that proceeding and variously argued that we should be subject to a range of requirements including an escrow account for capital spending, new investment obligations, and customer credits or price reductions.

On April 14, 2005, the Commission issued its Final Order in connection with this investigation. In this Final Order, the Commission ruled that the evidence in the record indicates Qwest will not be in compliance with the investment commitment at the conclusion of the AFOR in March, 2006, and if the current trend in Qwest's capital expenditures continues, there will be a shortfall of \$200 million or more by the end of the AFOR. The Commission also concluded that Qwest has an unconditional commitment to invest \$788 million over the life of the AFOR. Finally, the Commission ruled that if Qwest fails to satisfy this investment commitment, any shortfall must be credited or refunded to Qwest's New Mexico customers. The Commission also opened an enforcement and implementation docket to review Qwest's investments and consider the structure and size of any refunds or credits to be issued to customers. On May 12 and 13, 2005, we filed appeals in federal district court and in the New Mexico State Supreme Court, respectively, challenging the lawfulness of the Commission's Final Order. On May 31, 2005, the Commission issued an order, in response to a Qwest report filed on May 20, 2005, designating a hearing examiner to conduct proceedings addressing whether customer credits and refunds should be imposed on Qwest based on Qwest's investment levels as of June 30, 2005, and prior to the expiration of the AFOR in March 2006.

Qwest has vigorously argued, and will continue to argue, among other things, that the underlying purpose of the investment commitment set forth in the AFOR has been met in that Qwest has met all service quality and service deployment obligations under the AFOR; that, in light of this, it should not be held to a specific amount of investment; and that the Commission has failed to include all eligible investments in the calculation of how much Qwest has actually invested. Nevertheless, Qwest believes it is unlikely the Commission will reverse its determination that Qwest has an unconditional obligation to invest \$788 million over the term of the AFOR. In addition, Qwest has argued, and will continue to argue, that customer credits or refunds are an impermissible and illegal form of relief for the Commission to order in the event there is an investment shortfall.

Qwest believes there is a substantial likelihood that the ultimate outcome of this matter will result in it having to make expenditures or payments beyond those it would otherwise make in the normal course of business. These expenditures or payments could take the form of one or more of the following: penalties, capital investment, basic service rate reductions and customer refunds or credits. At this time, however, Qwest is not able to reasonably estimate the amount of these expenditures or payments and, accordingly, has not reserved any amount for such potential liability. Any final resolution of this matter could be material.

To the extent appropriate, we have provided reserves for the above matters. We have other regulatory actions pending in local regulatory jurisdictions, which call for price decreases, refunds or both. These actions are generally routine and incidental to our business.

## **Other Matters**

In January 2001, an amended class action complaint was filed in Denver District Court on behalf of a class of U S WEST stockholders of record as of June 30, 2000, the day of the U S WEST/QCII merger, alleging that QCII had a duty to pay a quarterly dividend that had been declared by the U S WEST Board of Directors on June 2, 2000. The complaint named as defendants QCII, the individuals who served on the U S WEST Board of Directors in June 2000, and Joseph Nacchio. Plaintiffs claimed that the defendants attempted to avoid paying the dividend by changing the record date from June 30, 2000 to July 10, 2000, a claim QCII denied. Plaintiffs sought damages of approximately \$273 million plus interest, a constructive trust upon QCII's assets in the amount of the dividend, costs, and attorneys' fees on behalf of the class, which was certified by the court in January 2005. On June 24, 2005, the court preliminarily approved a \$50 million settlement, almost half of which will be funded by the defendants' insurers. The settlement is still subject to final court approval, and will be reviewed at a hearing on August 30, 2005 to determine whether it is fair, just, reasonable and adequate as to the class. QCII has accrued an amount for the portion of the settlement that will be funded by it.

Several putative class actions relating to the installation of fiber optic cable in certain rights-of-way were filed against QCII on behalf of landowners on various dates and in various courts in California, Colorado, Georgia, Illinois, Indiana, Kansas, Mississippi, Missouri, North Carolina, Oregon, South Carolina, Tennessee and Texas. For the most part, the complaints challenge QCII's right to install its fiber optic cable in railroad rights-of-way. Complaints in Colorado, Illinois and Texas also challenge QCII's right to install fiber optic cable in utility and pipeline rights-of-way. The complaints allege that the railroads, utilities and pipeline companies own a limited property right-of-way that did not include the right to permit QCII to install QCII's fiber optic cable in the right-of-way without the Plaintiffs' consent. Most actions (California, Colorado, Georgia, Kansas, Louisiana, Mississippi, Missouri, North Carolina, Oregon, South Carolina, Tennessee and Texas) purport to be brought on behalf of state-wide classes in the named plaintiffs' respective states. Several actions purport to be brought on behalf of multi-state classes. The Illinois state court action purports to be on behalf of landowners in Illinois, Iowa, Kentucky, Michigan, Minnesota, Nebraska, Ohio and Wisconsin. A newly filed Illinois federal court action purports to be on behalf of landowners in Arkansas, California, Florida, Illinois, Indiana,



Missouri, Nevada, New Mexico, Montana and Oregon. The Indiana action purports to be on behalf of a national class of landowners adjacent to railroad rights-of-way over which QCII's network passes. The complaints seek damages on theories of trespass and unjust enrichment, as well as punitive damages.

On January 20, 2004, QCII filed a complaint in the District Court for the City and County of Denver against KMC Telecom LLC and several of its related parent or subsidiary companies (collectively, "KMC"). Subsequently, QCII filed an amended complaint to name additional defendants, including General Electric Capital Corporation ("GECC"), one of KMC's lenders, and GECC filed a complaint in intervention. QCII is seeking a declaration that a series of agreements with KMC and its lenders are not effective because conditions precedent were not satisfied and to recoup other damages and attorneys' fees and costs. These agreements would obligate QCII to pay a net incremental amount of approximately \$105 million if determined to be effective. GECC and KMC have asserted counterclaims for declaratory judgment and anticipatory breach of contract. GECC and KMC seek a declaration that the relevant agreements are in effect and claim monetary damages for anticipatory breach of the agreements and their attorneys' fees and costs. QCII has not reserved any amount for this matter.

The Internal Revenue Service, or IRS, proposed a tax adjustment for tax years 1994 through 1996. The principal issue involves QCII's allocation of costs between long-term contracts with customers for the installation of conduit or fiber optic cable and additional conduit or fiber optic cable retained by QCII. The IRS disputes QCII's allocation of the costs between it and third parties. Similar claims have been asserted against QCII with respect to the 1997 to 1998 and the 1998 to 2001 audit periods. The 1994-1996 claim is currently being litigated in the Tax Court and QCII does not believe the IRS will be successful, although the ultimate outcome is uncertain. If QCII were to lose this issue for the tax years 1994 through 1998, QCII estimates it would have to pay \$57 million plus interest pursuant to tax sharing agreements with the Anschutz Company relating to those time periods.

In 2004, QCII recorded income tax expense of \$158 million related to a change in the expected timing of deductions related to its tax strategy, referred to as the Contested Liability Acceleration Strategy ("CLAS"), which it implemented in 2000. CLAS is a strategy that sets aside assets to provide for the satisfaction of asserted liabilities associated with litigation in a tax efficient manner. CLAS accelerated deductions for contested liabilities by placing assets for potential litigation liabilities out of the control of the company and into trusts managed by a third party trustee. In July 2004, QCII was formally notified by the IRS that it was contesting the CLAS tax strategy. Also in July 2004, in connection with the preparation of its financial statements for the fiscal quarter ended June 30, 2004, and as a result of a series of notices on CLAS strategies issued by the IRS and the receipt of legal advice with respect thereto, QCII adjusted its accounting for CLAS as required by SFAS No. 109 "Accounting for Income Taxes." The change in expected timing of deductions caused an increase in QCII's liability for uncertain tax positions and a corresponding increase in its net operating loss carry-forwards ("NOLs"). Because QCII is not currently forecasting future taxable income sufficient to realize the benefits of this increase in its NOLs it recorded an increase in its valuation allowance on deferred tax assets as required by SFAS No. 109. Additionally, in September 2004 the IRS proposed a penalty of \$37 million on this strategy. QCII believes that the imposition of a penalty is not appropriate as it acted in good faith in implementing this tax strategy in reliance on two contemporaneous tax opinions and adequately disclosed this transaction to the IRS in its initial and subsequent tax returns. QCII intends to vigorously defend its position on this and other tax matters.

QCII has other tax related matters pending against it. QCII believes it has adequately provided for these matters.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

*Unless the context requires otherwise, references in this report to "Qwest," "we," "us," the "Company" and "our" refer to Qwest Corporation and its consolidated subsidiaries, and references to "QCII" refer to our ultimate parent company, Qwest Communications International Inc., and its consolidated subsidiaries.*

Certain statements set forth below under this caption constitute forward-looking statements. See "Special Note Regarding Forward-Looking Statements" at the end of this Item 2 for additional factors relating to such statements as well as for a discussion of certain risk factors applicable to our business, financial condition and results of operations.

### ***Business Overview and Presentation***

We provide local telecommunications and related services, IntraLATA long-distance services and data services within our local service area, which consists of the 14-state region of Arizona, Colorado, Idaho, Iowa, Minnesota, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Utah, Washington and Wyoming. Our operations are included in the consolidated operations of our ultimate parent, QCII, and generally account for the majority of QCII's consolidated revenue. Our telecommunications products and services are provided through our traditional telephone network located within our local service area. In addition to our operations, QCII maintains a wireless business (comprised of the wireless operations we transferred to an affiliate in May 2004) and a national fiber optic network. Through its fiber optic network, QCII provides the following wireline products and services that we do not provide:

- InterLATA long-distance services;
- Dedicated Internet access;
- Virtual private network;
- Internet dial access; and
- Professional services.

For certain other products and services we provide and for a variety of internal communications functions, we utilize QCII's fiber optic network to transport voice and data traffic. Also, through its fiber optic network, QCII provides nationally some data and Internet access services, including private line, ATM and Frame Relay, which are similar to what we provide within our local service area.

Our analysis presented below is organized to provide the information we believe will be instructive for understanding the relevant trends going forward. However, this discussion should be read in conjunction with our condensed consolidated financial statements in Item 1 of Part I of this report, including the footnotes thereto. Certain prior year revenue and expense amounts have been reclassified to conform to the current year presentations.

Our operations are integrated into and are part of the segments of the QCII consolidated group. The chief operating decision maker, or CODM, for us is the same as that for the consolidated group. The CODM makes resource allocation decisions and assessments of financial performance for the consolidated group based on wireline, wireless and other segmentation. For more information about QCII's reporting segments, see QCII's annual report on Form 10-K for the year ended December 31, 2004. Our business contributes to the segments reported by QCII, but the QCII CODM reviews our financial information only in connection with our quarterly and annual reports. See further discussion in Note 5—Contributions to QCII Segments and Revenue Information to our condensed consolidated financial statements in Item 1 of Part I of this report.

## ***Business Trends***

Our results continue to be impacted by a number of factors influencing the telecommunications industry as follows:

- Industry competition is based primarily on pricing, packaging of services and features, quality of service and increasingly on meeting customer care needs. We expect this trend to continue. Our on-going response to industry competition has included initiatives to retain and win-back customers by rolling out new or expanded services such as DSL, bundling of expanded feature-rich products and improving the quality of our customer service.
- The consolidation trend in the telecommunications industry, as exemplified by the current proposed mergers, could have significant impact on customer choice and may impact our efforts to win customers and strengthen our position as a national provider of communications services. Our revenues and expenses may also be impacted as partners to the mergers integrate and consolidate their operations.
- We expect technology substitution such as wireless substitution for wireline telephones, cable telephony substitution for wireline telephony and cable modem substitution for dial up modem lines and DSL to continue to cause additional access line losses.
- Employees represented by labor unions represent a significant portion of our work force and of the industry. We are currently in negotiations with the Communications Workers of America ("CWA") and the International Brotherhood of Electrical Workers ("IBEW") regarding agreements that expire on August 13, 2005. The impact of these negotiations could have a material impact on our future financial results and financial position from changes to our wage and benefit structure including, but not limited to, wage rates, health care costs, pensions and post-retirement benefit obligations.
- Our results continue to be impacted by regulatory responses to the competitive landscape for both our local and long-distance services. For instance, recent FCC decisions, including its Triennial Review Remand Order, may facilitate some carriers converting existing special access transport services to lower priced UNE transport. Such conversions could have a significant impact on our future financial results.
- We expect business users of telecommunication services to increasingly want to receive all of their services from one provider.

## ***Results of Operations***

### **Overview**

We generate revenue from the provision of voice services, data and Internet services, other services and services to our affiliates. Certain prior period revenue and expense amounts have been reclassified to conform to the current period presentation. Depending on the product or service purchased, a customer may pay an up-front fee, a monthly fee, a usage charge or a combination of these. The following is a description of the sources of our revenue:

- *Voice services.* Voice services revenue includes local voice services, IntraLATA long-distance voice services and access services. Local voice services revenue includes revenue from basic local exchange services, switching services, custom calling features, enhanced voice services, operator services, collocation services and related equipment. Local voice services revenue also includes revenue from the provision of network transport, billing services and access to our local network on a wholesale basis. IntraLATA long-distance voice services revenue includes revenue from IntraLATA long-distance services within our local service area. Access services revenue includes fees charged to other long-distance providers to connect to our network.

- *Data and Internet services.* Data and Internet services revenue includes data services (such as traditional private lines, wholesale private lines, frame relay, ISDN and ATM) and Internet services (such as DSL, Internet dial access and related equipment).
- *Other services.* Other services revenue is predominantly derived from the sublease of some of our unused real estate assets, such as space in our office buildings, warehouses and other properties.
- *Affiliate services.* Affiliate revenue is derived from telecommunications and other services provided to our affiliated entities. We generally provide the same telecommunications products and services to our affiliated entities as we do in the marketplace. These services include both retail and wholesale products and services. In addition, we provide billing, collection, joint marketing, lease of space, and other non-telecommunications services to affiliates.

In order to better serve the similar needs of our small business and consumer customers, we have combined these customers into a new channel, which we refer to as "mass markets," and have reclassified our small business customers for all periods presented. The following table summarizes our results of operations for the three and six-months ended June 30, 2005 and 2004:

	Three Months Ended June 30,		Increase/ (Decrease)	% Change	Six Months Ended June 30,		Increase/ (Decrease)	% Change
	2005	2004			2005	2004		
	(Dollars in millions)				(Dollars in millions)			
Operating revenues	\$ 2,542	\$ 2,564	\$ (22)	(1)%	\$ 5,093	\$ 5,182	\$ (89)	(2)%
Operating expenses	1,973	2,077	(104)	(5)%	3,939	4,071	(132)	(3)%
Operating income	569	487	82	17%	1,154	1,111	43	4%
Other expense—net	168	141	27	19%	330	285	45	16%
Income before income taxes and discontinued operations	401	346	55	16%	824	826	(2)	nm
Income tax expense	(151)	(136)	(15)	(11)%	(312)	(322)	10	3%
Income from continuing operations	250	210	40	19%	512	504	8	2%
Loss from discontinued operations, net of tax of \$0, \$7, \$0 and \$34, respectively	—	(12)	12	nm	—	(53)	53	nm
Net income	\$ 250	\$ 198	\$ 52	26%	\$ 512	\$ 451	\$ 61	14%

nm—percentages greater than 200% and comparisons between positive and negative values or to zero values are considered not meaningful.

## Operating Revenues

The following table compares operating revenues including detail of customer channels for the three and six months ended June 30, 2005 and 2004:

	Three Months Ended June 30,		Increase/ (Decrease)	% Change	Six Months Ended June 30,		Increase/ (Decrease)	% Change
	2005	2004			2005	2004		
	(Dollars in millions)				(Dollars in millions)			
Voice services	\$ 1,722	\$ 1,795	\$ (73)	(4)%	\$ 3,430	\$ 3,645	\$ (215)	(6)%
Data and Internet services	538	541	(3)	(1)%	1,093	1,073	20	2%
Affiliate services	280	226	54	24%	563	455	108	24%
Other services	2	2	—	—	7	9	(2)	(22)%
Total operating revenues	\$ 2,542	\$ 2,564	\$ (22)	(1)%	\$ 5,093	\$ 5,182	\$ (89)	(2)%

nm—percentages greater than 200% and comparisons between positive and negative values or to zero values are considered not meaningful.

### ***Voice Services***

The decrease in voice services revenue for the three and six months ended June 30, 2005 was primarily due to access line losses in our business and mass markets channels from competitive pressures and technology substitution partially offset by Universal Service Fund, or USF, rate increases. The decrease in our wholesale channel is primarily due to the sale of our payphone business in August 2004 partially offset by a favorable settlement of \$23 million from a customer billing dispute during the quarter ended June 30, 2005. The following table shows our access lines by channel as of June 30, 2005 and 2004:

	Access Lines *			
	As of June 30,			
	2005	2004	Increase/ (Decrease)	% Change
	(in thousands)			
Business	2,489	2,655	(166)	(6)%
Mass Markets	10,790	11,283	(493)	(4)%
Wholesale	1,807	1,901	(94)	(5)%
Total	15,086	15,839	(753)	(5)%

\* We may modify the channel classification of our access lines from time to time in our efforts to better approximate the related revenue channels and better reflect how we manage our business.

### ***Data and Internet Services***

The decrease in data and Internet services for the three months ended June 30, 2005 was primarily due to the termination of our wholesale modem services product, a decrease in Frame Relay revenue and select ISDN customers migrating to their own platform in the quarter ended June 30, 2005 partially offset by the below mentioned subscriber growth.

The increase in data and Internet services revenue for the six months ended June 30, 2005 was primarily due to subscriber growth of our DSL product as a result of our expanded service availability and increased penetration of DSL in our mass markets channel partially offset by the termination of our wholesale modem services product in April 2005.

### ***Affiliate Services***

The increase in affiliate services revenue for the three and six months ended June 30, 2005 was primarily caused by increases in switched access, private line and billing and collection services provided to our long-distance affiliate and Qwest Communications Corporation. The increase in these services was offset by a reduction in service revenues from external customers and was associated with growth in the affiliate's long-distance business.

## Operating Expenses

The following table provides further detail regarding our operating expenses for the three and six months ended June 30, 2005 and 2004.

	Three Months Ended June 30,				Six Months Ended June 30,			
	2005	2004	Increase/ (Decrease)	% Change	2005	2004	Increase/ (Decrease)	% Change
	(Dollars in millions)				(Dollars in millions)			
Operating expenses:								
Cost of sales:								
Affiliate costs	\$ 65	\$ 101	\$ (36)	(36)%	\$ 118	\$ 170	\$ (52)	(31)%
Network expenses	57	51	6	12%	104	90	14	16%
Employee-related costs	334	382	(48)	(13)%	695	764	(69)	(9)%
Other non-employee related costs	133	115	18	16%	258	224	34	15%
Total cost of sales	589	649	(60)	(9)%	1,175	1,248	(73)	(6)%
Selling, general and administrative:								
Affiliate costs	298	324	(26)	(8)%	598	603	(5)	(1)%
Property and other taxes	100	92	8	9%	187	159	28	18%
Bad debt	17	(34)	51	nm	40	3	37	nm
Restructuring and severance related costs	(3)	54	(57)	nm	2	56	(54)	(96)%
Employee-related costs	143	136	7	5%	284	298	(14)	(5)%
Other non-employee related costs	166	158	8	5%	320	339	(19)	(6)%
Total selling, general and administrative	721	730	(9)	(1)%	1,431	1,458	(27)	(2)%
Depreciation	578	584	(6)	(1)%	1,157	1,159	(2)	—
Amortization of capitalized software and other intangible assets	85	95	(10)	(11)%	176	187	(11)	(6)%
Asset impairment charges	—	19	(19)	nm	—	19	(19)	nm
Total operating expenses	\$ 1,973	\$ 2,077	\$ (104)	(5)%	\$ 3,939	\$ 4,071	\$ (132)	(3)%

nm—percentages greater than 200% and comparisons between positive and negative values or to zero values are considered not meaningful.

### Cost of Sales

Cost of sales includes network costs, salaries and wages, benefits, materials and supplies, USF charges, contracted engineering services and computer systems support. Cost of sales as a percentage of revenue, excluding affiliate, has remained relatively flat and cost of sales for the three and six months ended June 30, 2005 has decreased due to the following:

- Decreased employee-related costs, such as salaries and wages, benefits and overtime primarily due to employee reductions from our restructuring plans and continued focus on containing our employee-related costs and productivity improvements.
- Decreased affiliate costs due to overall cost reductions at our affiliates and a shift in focus of information technology projects to other affiliates.

These decreases were partially offset by:

- Increased other non-employee related costs due to a favorable bankruptcy settlement of \$16 million in the first quarter of 2004 as well as a 2% increase in the USF rate during the six months ended June 30, 2005.

## ***Selling, General and Administrative Expenses***

Selling, general and administrative, or SG&A, expenses include taxes other than income taxes, bad debt charges, salaries and wages not directly attributable to the provision of products or services, benefits, sales commissions, rent for administrative space, advertising, professional service fees and computer systems support.

SG&A expenses decreased in the three and six months ended June 30, 2005 primarily due to the following:

- Decreased restructuring and severance related costs as we complete our restructuring plans.
- Decreased other non-employee related costs in the six months ended June 30, 2005 primarily due to an \$18 million legal accrual in the quarter ended June 30, 2004 offset in the quarter by increased marketing related costs.
- Decreased employee-related costs, such as salaries and wages, benefits and overtime for the six months ended June 30, 2005 due to employee reductions from our restructuring efforts and the sale of our payphone operations. These expenses increased in the quarter ended June 30, 2005 compared to the quarter ended June 30, 2004 primarily due to a decrease in capitalized labor as a result of reduced software development.
- Decreased affiliate expenses which include services for corporate administration, information technology, sales, advertising and technical support. Affiliate expenses decreased for the three and six months ended June 30, 2005 primarily as a result of a decrease in labor and expenses associated with information technology projects and a one time restructuring charge incurred in 2004 offset by expenses allocated for outsourced information technology services.

These decreases were partially offset by:

- Increased bad debt expense primarily due to favorable settlements during the second quarter of 2004 totaling \$45 million from customers emerging from bankruptcy partially offset by improved collection practices.
- Increased property and other taxes primarily due to a one-time expense reduction from a successful property tax settlement of \$28 million for the first quarter of 2004.

## ***Combined Pension and Post-Retirement Benefits***

Our employees participate in the QCII pension and other post-employment benefit plans. We refer to the combined pension and post-retirement benefit costs as net pension expense. Our results include net pension expenses allocated to us by QCII of \$55 million and \$50 million for the three months ended June 30, 2005 and 2004, respectively, and \$110 million and \$106 million for the six months ended June 30, 2005 and 2004, respectively. The net pension expense is a function of the amount of pension and post-retirement benefits earned, interest on projected benefit obligations, amortization of costs and credits from prior benefit changes and the expected return on the assets held in the various plans. The increase in net pension expense for the three and six month periods ended June 30, 2005 as compared to the three and six month period ended June 30, 2004 is primarily due to decreased expected return on investments in the benefit trusts, completion of amortization of the transition asset in 2004, and amortization of actuarial losses caused by the volatile equity markets and lower discount rates partially offset by reductions in expense due to headcount reduction, plan design changes, and the inclusion of the Medicare Part D subsidy in the first quarter of 2005 versus the delayed recognition during 2004. The net pension expense is allocated to cost of sales and SG&A.

## Total Other Expense—Net

Other expense—net generally includes interest expense, net of capitalized interest, and other income—net, which includes interest income. Components of other expense—net were as follows:

	Three Months Ended June 30,					Six Months Ended June 30,			
	2005	2004	Increase/ (Decrease)	% Change		2005	2004	Increase/ (Decrease)	% Change
	(Dollars in millions)					(Dollars in millions)			
Interest expense—net	\$ 151	\$ 147	\$ 4	3%	\$ 300	\$ 294	\$ 6	2%	
Loss on early retirement of debt—net	37	—	37	nm	37	—	37	nm	
Other income—net	(20)	(6)	(14)	nm	(7)	(9)	2	22%	
Total other expense—net	\$ 168	\$ 141	\$ 27	19%	\$ 330	\$ 285	\$ 45	16%	

nm—percentages greater than 200% and comparisons between positive and negative values or to zero values are considered not meaningful.

*Other expense—net.* Other expense—net increased for the three months ended June 30, 2005 due to a loss of \$37 million as a result of cash tender offers and the issuance of new debt in June 2005 partially offset by a \$13 million gain due to the change in fair value of the swap agreements that we terminated in the quarter ended June 30, 2005. For more information on these transactions, please see Note 3—Borrowings to our condensed consolidated financial statements in Item 1 of Part I of this report.

## Income Taxes

The effective income tax rate is the provision for income taxes as a percentage of pre-tax income. Our effective income tax rate for the three months ended June 30, 2005 decreased to 37.7% as compared to 39.3% for the three months ended June 30, 2004. The rate also decreased to 37.9% for the six months ended June 30, 2005 as compared to 39.0% for the six months ended June 30, 2004. The decrease was primarily due to the non-taxable income associated with the subsidy under the Medicare Prescription Drug, Improvement, and Modernization Act of 2003.

## Liquidity and Capital Resources

We are a wholly owned subsidiary of Qwest Services Corporation, or QSC, which is wholly owned by QCII. As such, factors relating to or affecting QCII's liquidity and capital resources could have material impacts on us, including changes in the market's perception of us, impacts on our credit ratings and access to capital markets.

QCII and its consolidated subsidiaries had total borrowings of \$17.5 billion at June 30, 2005 and \$17.3 billion at December 31, 2004. Some of the borrowings of QCII and QSC are secured by liens on our stock. As a result, ownership of our stock could transfer if either QCII or QSC were to default on its debt obligations.

QCII has cash management arrangements between certain of its subsidiaries that include lines of credit, inter-company obligations, capital contributions and dividends. As part of these cash management arrangements, affiliates provide lines of credit to certain other affiliates. Amounts outstanding under these lines of credit and inter-company obligations vary from time to time and are classified as short-term borrowings.

## Near-Term View

We had \$345 million in cash and cash equivalents and \$92 million of short-term investments available at June 30, 2005. For the quarter ended June 30, 2005, our primary source of funds was cash



provided by operating activities. During 2005, we expect to use our available excess cash primarily to pay dividends to our parent, to make additional investment to our network or pay down debt maturities. For the six months ended June 30, 2005 we declared dividends of \$1 billion to our parent.

Our working capital deficit as of June 30, 2005 improved \$870 million since December 31, 2004. This reduction of our working capital deficit was attributable to our debt borrowing net of repayment activity in the second quarter of 2005 which reduced the current portion of our long-term borrowings as further discussed in Note 3—Borrowings to our condensed consolidated financial statements in Item 1 of Part 1 of this report as well as reduced dividends payable and affiliate short-term liabilities paid in the quarter ended June 30, 2005.

We continue to pursue our strategy to improve our near-term liquidity and our capital structure in order to reduce financial risk. During the quarter ended June 30, 2005, we have taken the following measures to improve our near-term financial position:

- On June 17, 2005, QC issued a total of \$1.15 billion of new debt consisting of \$750 million in floating rate notes due in 2013 with interest at LIBOR plus 3.25% (6.67% for the current payment period) and \$400 million notes due in 2015 with an interest rate of 7.625% per annum.
- On June 7, 2005, QC announced cash tender offers for the purchase of up to \$250 million of aggregate principal amount of QC's 6.625% notes due September 15, 2005 (the "QC 6.625% Notes") and up to \$150 million of aggregate principal amount of QC's 6.125% notes due November 15, 2005 (the "QC 6.125% Notes"). QC received and accepted tenders of approximately \$211 million face amount of QC 6.625% Notes for \$216 million, including accrued interest of \$4 million, and approximately \$129 million face amount of QC 6.125% Notes for \$131 million, including accrued interest of \$1 million.
- On June 20 and June 23, 2005, QC pre-paid an aggregate of \$750 million face amount of its \$1.25 billion term loan maturing in June 2007 for \$775 million, including accrued interest of \$2 million. This and the above transactions resulted in a loss of \$37 million.
- On May 27, 2005, QC announced registered exchange offers for its 7.875% notes due 2011 (the "2011 QC Notes") and its 8.875% notes due 2012 (the "2012 QC Notes") pursuant to the registration rights agreements that QC entered into in connection with the issuance of these outstanding notes. QC completed the registered exchange offers for the 2011 QC notes and 2012 QC notes on July 5, 2005.

The current working capital deficit is primarily due to accounts payable owed to our affiliates and dividends that we declare to QSC. The timing of cash payments for declared dividends to QSC is at our discretion in consultation with QSC. We continue to produce significant cash from operating activities, and we believe that our cash on hand together with our cash flows from operations should be sufficient to meet our cash needs through the next twelve months. However, if we or QCII become subject to significant judgments, settlements or tax payments, such as the potential CLAS obligation, as further discussed in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report, we or QCII could be required to make significant payments that we or QCII do not have the resources to make. The magnitude of any settlements or judgments resulting from these actions could materially and adversely affect QCII's ability to meet its debt obligations and its financial condition, potentially impacting its credit ratings, its ability to access capital markets and its compliance with debt covenants. In addition, the magnitude of any settlement or judgment may cause QCII to draw down significantly on its cash balances, which might force it to obtain additional financing or explore other methods to generate cash. Such methods could include issuing additional securities or selling assets.

To the extent that QCII's EBITDA (as defined in QCII's debt covenants) is reduced by cash judgments or settlements, its debt to consolidated EBITDA ratios under certain debt agreements will

be adversely affected, which could reduce QCII's liquidity and flexibility due to potential restrictions on drawing on its line of credit and potential restrictions on incurring additional debt under certain provisions of its debt agreements. As a wholly owned subsidiary of QCII, our business operations and financial condition could be similarly affected, potentially impacting our credit ratings and access to capital markets. In addition, a three-year revolving credit facility established by QSC in 2004 (the "2004 QSC Credit Facility") contains various limitations, including a restriction on using any proceeds from the facility to pay settlements or judgments relating to investigation and securities actions discussed in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report.

### Long-Term View

We have historically operated with a working capital deficit as a result of the issues discussed above and due to our practice of declaring regular cash dividends. We expect this trend to continue. As discussed below, we continue to generate substantial cash from operations. We believe that cash provided by operations, combined with our current cash position and continued access to capital markets to refinance our current portion of debt, should allow us to meet our cash requirements, for the foreseeable future.

In addition to our periodic need to obtain financing in order to meet our debt obligations as they come due, we may also need to obtain additional financing or investigate other methods to generate cash (such as further cost reductions or the sale of assets) if cash provided by our and QCII's operations does not improve, if revenue and cash provided by operations decline, if economic conditions weaken, if competitive pressures increase or if we or QCII become subject to significant judgments, settlements or tax payments as further discussed in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report. In the event of an adverse outcome in one or more of these matters, we or QCII could be required to make significant payments that we do not have the resources to make. The magnitude of any settlements or judgments resulting from these actions could materially and adversely affect QCII's ability to meet its debt obligations and its financial condition, potentially impacting its credit ratings, its ability to access capital markets and its compliance with debt covenants. In addition, the magnitude of any settlements or judgments may cause QCII to draw down significantly on its cash balances, which might force it to obtain additional financing or explore other methods to generate cash. Such methods could include issuing additional securities or selling assets. As a wholly owned subsidiary of QCII, our business operations and financial condition could be similarly affected, potentially impacting our credit ratings and access to the capital markets.

The 2004 QSC Credit Facility makes available to QSC \$750 million of additional credit subject to certain restrictions as described below, and is currently undrawn. This facility has a cross payment default provision, and this facility and certain other debt issues of QCII and its other subsidiaries also have cross acceleration provisions. When present, such provisions could have a wider impact on liquidity than might otherwise arise from a default or acceleration of a single debt instrument. These provisions generally provide that a cross default under these debt instruments could occur if:

- QCII fails to pay any indebtedness when due in an aggregate principal amount greater than \$100 million;
- any indebtedness is accelerated in an aggregate principal amount greater than \$100 million (\$25 million in the case of one of the debt instruments); or
- judicial proceedings are commenced to foreclose on any of QCII's assets that secure indebtedness in an aggregate principal amount greater than \$100 million.

Upon such a cross default, the creditors of a material amount of QCII's debt may elect to declare that a default has occurred under their debt instruments and to accelerate the principal amounts due such creditors. Cross acceleration provisions are similar to cross default provisions, but permit a default in a second debt instrument to be declared only if in addition to a default occurring under the first debt instrument, the indebtedness due under the first debt instrument is actually accelerated. As a wholly owned subsidiary of QCII, our business operations and financial condition could be affected, potentially impacting our credit ratings and access to the capital markets. In addition, the 2004 QSC Credit Facility contains various limitations, including a restriction on using any proceeds from the facility to pay settlements or judgments relating to the investigation and securities actions discussed in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report.

## Historical View

	For the Six Months Ended June 30,	
	2005	2004
	(Dollars in millions)	
<b>Cash Flows:</b>		
Provided by operating activities	\$ 1,711	\$ 1,646
Used for investing activities	(378)	(659)
Used for financing activities	(1,330)	(1,321)
Net increase (decrease) in cash and cash equivalents	\$ 3	\$ (334)

### Operating Activities

Our cash provided by operating activities increased in the six months ended June 30, 2005 compared to the same period of 2004 primarily due to increased net income after adjusting for non-cash items offset by \$239 million of net charges in our operating assets and liabilities.

Our employees participate in the QCII pension, post-retirement and other post-employment benefit plans. QCII does not anticipate a requirement to make any significant contribution to the QCII retirement plans in 2005.

### Investing Activities

We used significantly less cash for our investing activities during the six months ended June 30, 2005 as compared to the six months ended June 30, 2004 primarily due to decreased capital expenditures due to decreased DSL deployment and lower local network infrastructure spending due, in part, to our reuse programs as well as from a \$33 million sales and use tax refund received in the second quarter of 2005, however, we expect that our 2005 capital expenditures will approximate 2004 levels.

### Financing Activities

Cash used for financing activities increased slightly for the six months ended June 30, 2005 compared to the same period in 2004. The increase in cash used for financing activities was primarily attributable to collections on a note receivable in the quarter ended June 30, 2004 from affiliate partially offset by lower dividends paid in the quarter ended June 30, 2005. Our existing debt covenants do not limit the amount of dividends we can pay to our parent. At June 30, 2005, we were in compliance with all provisions or covenants of our borrowings.

*Credit ratings*

The table below summarizes our long-term debt ratings at June 30, 2005 and December 31, 2004:

S&P	BB-
Fitch	BB
Moody's	Ba3

Debt ratings by the various rating agencies reflect each agency's opinion of the ability of the issuers to repay debt obligations as they come due. In general, lower ratings result in higher borrowing costs and/or impaired ability to borrow. A security rating is not a recommendation to buy, sell, or hold securities and may be subject to revision or withdrawal at any time by the assigning rating organization.

Given our current credit ratings, as noted above, our ability to raise additional capital under acceptable terms and conditions may be negatively impacted.

**Risk Management**

We are exposed to market risks arising from changes in interest rates. The objective of our interest rate risk management program is to manage the level and volatility of our interest expense. We may employ derivative financial instruments to manage our interest rate risk exposure.

We had approximately \$1.25 billion of floating-rate debt as of June 30, 2005 and December 31, 2004 which was exposed to changes in interest rates. This exposure is linked to LIBOR. A hypothetical increase of 100 basis points in LIBOR would increase annual pre-tax interest expense by \$13 million in 2005. As of June 30, 2005 and December 31, 2004, we had approximately \$61 million and \$400 million, respectively, of long-term fixed rate debt obligations maturing in the following 12 months. We are exposed to changes in interest rates at any time that we choose to refinance this debt. A hypothetical 100 or 200 basis point increase in the interest rates on this debt would not have a material effect on our earnings.

As of June 30, 2005, our proportionate share of QCII's investments was \$315 million of cash invested in money market instruments and \$73 million invested in auction rate securities. As interest rates change, so will the interest income derived from these instruments. Assuming that the investment balance was to remain constant, a hypothetical increase of 100 basis points in money market rates would increase annual interest income by \$4 million. As of June 30, 2005, our share of QCII's investment in fixed rate short-term investments was \$19 million; however the income from these investments is not subject to interest rate volatility due to their fixed rate structure.

## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-Q contains or incorporates by reference forward-looking statements about our financial condition, results of operations and business. These statements include, among others:

- statements concerning the benefits that we expect will result from our business activities and certain transactions we have completed, such as increased revenues, decreased expenses and avoided expenses and expenditures; and
- statements of our expectations, beliefs, future plans and strategies, anticipated developments and other matters that are not historical facts.

These statements may be made expressly in this document or may be incorporated by reference to other documents we will file with the Securities and Exchange Commission ("SEC"). You can find many of these statements by looking for words such as "believes," "expects," "anticipates," "estimates," or similar expressions used in this report or incorporated by reference in this report.

These forward-looking statements are subject to numerous assumptions, risks and uncertainties that may cause our actual results to be materially different from any future results expressed or implied by us in those statements. Some of these risks are described below under "Risk Factors." These risk factors should be considered in connection with any subsequent written or oral forward-looking statements that we or persons acting on our behalf may issue. We do not undertake any obligation to review or confirm analysts' expectations or estimates or to release publicly any revisions to any forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events. Further, the information contained in this document is a statement of our intention as of the date of this filing and is based upon, among other things, the existing regulatory environment, industry conditions, market conditions and prices, the economy in general and our assumptions as of such date. We may change our intentions, at any time and without notice, based upon any changes in such factors, in our assumptions or otherwise.

## RISK FACTORS

### Risks Affecting Our Business

***We face pressure on profit margins as a result of increasing competition, including product substitution, which could adversely affect our operating results and financial performance.***

We compete in a rapidly evolving and highly competitive market, and we expect competition to intensify. We have faced greater competition in our core local business from cable companies, wireless providers (including our affiliate), facilities-based providers using their own networks as well as those leasing parts of our network (unbundled network elements) and resellers. Regulatory developments have generally increased competitive pressures on our business, such as the November 2003 decision of the Federal Communications Commission ("FCC") allowing for number portability from wireline to wireless phones.

Due to these and other factors, we believe competitive telecommunications providers are no longer hindered by historical barriers to entry. As a result, we are seeking to distinguish ourselves from our competitors through a number of customer service initiatives. These initiatives include expanded product bundling, simplified billing, improved customer support and other ongoing measures. However, these initiatives are new and unproven. We may not have sufficient resources to distinguish our service levels from those of our competitors, and we may not be successful in integrating our product offerings, especially products for which we act as a reseller. Even if we are successful, these initiatives may not be sufficient to offset our continuing loss of access lines. Please see "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 2 of Part I of this report for more information regarding trends affecting our access lines.

We have also begun to experience and expect further increased competitive pressure from telecommunications providers either consolidating with other providers or reorganizing their capital structure to more effectively compete against us. As a result of these increased competitive pressures, we have been and may continue to be forced to respond with lower profit margin product offerings and pricing schemes in an effort to retain and attract customers. These pressures could adversely affect our operating results and financial performance.

***Rapid changes in technology and markets could require substantial expenditure of financial and other resources in excess of contemplated levels, and any inability to respond to those changes could reduce our market share.***

The telecommunications industry is experiencing significant technological changes, and our ability to execute our business plans and compete depends upon our ability to develop new products and accelerate the deployment of advanced new services, such as broadband data and video services. The development and deployment of new products could require substantial expenditure of financial and other resources in excess of contemplated levels. If we are not able to develop new products to keep pace with technological advances, or if such products are not widely accepted by customers, our ability to compete could be adversely affected and our market share could decline. Any inability to keep up with changes in technology and markets could also adversely affect the trading price of our securities and our ability to service our debt.

***If we are not able to stem the loss of our access lines or grow other areas of our business to compensate for these losses, our revenue will continue to decline.***

Our revenue decline over the past few years is largely attributable to our continued loss of access lines, which is a result of increased competition and technology substitution (such as wireless and cable substitution for wireline telephony). We are seeking to improve our competitive position through product bundling and other sales and marketing initiatives. However, we may not be successful in these

efforts. If we are not successful and our revenue declines materially without corresponding cost reductions, this will cause a material deterioration to our results of operations and financial condition and adversely affect our ability to service debt and pay other obligations.

### **Risks Relating to Legal and Regulatory Matters**

***Any adverse outcome of the major lawsuits pending against QCII and us or the investigation of QCII's business currently being conducted by the U.S. Attorney's Office could have a material adverse impact on our financial condition and operating results, on the trading price of our debt securities and on our ability to access the capital markets.***

The Department of Justice investigation and the securities actions described in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report present material and significant risks to QCII and us. In many of the securities actions, the plaintiffs seek tens of millions of dollars in damages or more, and in one putative class action lawsuit, lead counsel for the plaintiffs has indicated that plaintiffs will seek damages in the tens of billions of dollars. The outcomes in any cases which have been or may be brought by the U.S. Attorney's Office or the SEC against former officers or employees of QCII may have a negative impact on the outcome of certain of these legal actions.

Further, the size, scope and nature of the restatements of QCII's consolidated financial statements for 2001 and 2000, which are described in its Annual Report on Form 10-K/A for the fiscal year ended December 31, 2002 ("QCII's 2002 Form 10-K/A"), affect the risks presented by these investigations and actions, as these matters involve, among other things, QCII's prior accounting practices and related disclosures. Plaintiffs in certain of the securities actions have alleged QCII's restatement of items in support of their claims. We can give no assurance as to the impacts on QCII's or our financial results or financial condition that may ultimately result from all of these matters. During 2003 and 2004, QCII recorded reserves in its financial statements totaling \$750 million in connection with the investigations and securities actions. The \$750 million reserve was reduced by \$125 million in December 2004 as a result of a payment in that amount in connection with a settlement in October 2004 of the SEC's investigation of QCII. The remaining reserve amount represents a final payment to be made in connection with the SEC settlement in the amount of \$125 million and the minimum estimated amount of loss QCII believes is probable with respect to the securities actions. However, the ultimate outcomes of these matters are still uncertain and there is a significant possibility that the amount of loss QCII ultimately incurs could be substantially more than the reserve QCII has provided. If the recorded reserve that will remain after QCII has paid the amount owed under the SEC settlement is insufficient to cover these matters, QCII will need to record additional charges to its statement of operations in future periods.

An adverse outcome with respect to the U.S. Attorney's Office investigation could have a material and significant adverse impact upon QCII and us. Additionally, QCII continues to defend against the securities actions vigorously and is currently unable to provide any estimate as to the timing of the resolution of these actions. Any settlement of or judgment in one or more of these actions substantially in excess of QCII's recorded reserves could have a significant impact on QCII and us, and we can give no assurance that QCII or we will have the resources available to pay any such judgment. The magnitude of any settlement or judgment resulting from these actions could materially and adversely affect QCII's and our ability to meet our debt obligations and our financial condition, potentially impacting our credit ratings, our ability to access capital markets and our compliance with debt covenants. In addition, the magnitude of any settlement or judgment may cause QCII or us to draw down significantly on our cash balances, which might force us to obtain additional financing or explore other methods to generate cash. Such methods could include issuing additional securities or selling assets.

Further, given the size and nature of our business, QCII and we are subject from time to time to various other lawsuits which, depending on their outcome, may have a material adverse effect on QCII's and our financial position. Thus, QCII and we can give no assurances as to the impacts on our financial results or financial condition as a result of these matters.

***Continued scrutiny of QCII's financial disclosures could reduce investor confidence and cause the trading price for our debt securities to decline.***

As a result of QCII's past accounting issues and the increased scrutiny of financial disclosures, investor confidence in QCII has suffered and could suffer further. As discussed earlier, the U.S. Attorney's Office is currently conducting an investigation of, without limitation, transactions related to the various adjustments and restatements described in QCII's 2002 Form 10-K/A and transactions between QCII and certain of its vendors and certain investments in the securities of those vendors by individuals associated with QCII, and certain prior disclosures made by QCII. Although, as described above, QCII has entered into a settlement with the SEC concerning the SEC's investigation of QCII, in March 2005, the SEC filed suit against QCII's former Chief Executive Officer, Joseph Nacchio, two of its former Chief Financial Officers, Robert Woodruff and Robin Szeliga, and other former officers and employees. In February 2005, a criminal indictment was returned against Marc Weisberg, a former QCII executive, in federal district court in Colorado. The indictment alleges that Mr. Weisberg violated federal laws by seeking and obtaining investment opportunities for himself and others in vendors that did or sought to do business with QCII. In June 2005, Ms. Szeliga reached an agreement in principle with the SEC staff to settle the actions against her alleging civil fraud and other claims and in July 2005, she pleaded guilty to a criminal charge of insider trading. Other former QCII officers or employees have entered into settlements with the SEC involving civil fraud and other claims in which they neither admitted nor denied the allegations against them. Civil and criminal trials in the matters discussed in this paragraph could take place in the future. Evidence that is introduced at such trials and in other matters may result in further scrutiny by governmental authorities and others.

The existence of this heightened scrutiny could adversely affect investor confidence and cause the trading price for our debt securities to decline.

***We operate in a highly regulated industry, and are therefore exposed to restrictions on our manner of doing business and a variety of claims relating to such regulation.***

Our operations are subject to extensive federal regulation, including the Communications Act of 1934, as amended, and FCC regulations thereunder. We are also subject to the applicable laws and regulations of various states, including regulation by PUCs and other state agencies. Federal laws and FCC regulations generally apply to regulated interstate telecommunications (including international telecommunications that originate or terminate in the United States), while state regulatory authorities generally have jurisdiction over regulated telecommunications services that are intrastate in nature. The local competition aspects of the Telecommunications Act of 1996 are subject to FCC rulemaking, but the state regulatory authorities play a significant role in implementing those FCC rules. Generally, we must obtain and maintain certificates of authority from regulatory bodies in most states where we offer regulated services and must obtain prior regulatory approval of rates, terms and conditions for our intrastate services, where required. Our businesses are subject to numerous, and often quite detailed, requirements under federal, state and local laws, rules and regulations. Accordingly, we cannot ensure that we are always in compliance with all these requirements at any single point in time. The agencies responsible for the enforcement of these laws, rules and regulations may initiate inquiries or actions based on their own perceptions of our conduct, or based on customer complaints.

Regulation of the telecommunications industry is changing rapidly, and the regulatory environment varies substantially from state to state. All of our operations are also subject to a variety of environmental, safety, health and other governmental regulations. There can be no assurance that



future regulatory, judicial or legislative activities will not have a material adverse effect on our operations, or that regulators or third parties will not raise material issues with regard to our compliance or noncompliance with applicable regulations.

We monitor our compliance with federal, state and local regulations governing the discharge and disposal of hazardous and environmentally sensitive materials, including the emission of electromagnetic radiation. Although we believe that we are in compliance with such regulations, any such discharge, disposal or emission might expose us to claims or actions that could have a material adverse effect on our business, financial condition and operating results.

### **Risks Affecting Our Liquidity**

*QCII's high debt levels, the restrictive terms of its debt instruments and the substantial litigation pending against it pose risks to our viability and may make us more vulnerable to adverse economic and competitive conditions, as well as other adverse developments.*

Our ultimate parent, QCII, is highly leveraged on a consolidated basis. As of June 30, 2005, our consolidated debt was \$7.7 billion, which is included in QCII's total consolidated debt of \$17.5 billion as of such date. A considerable amount of our and QCII's debt obligations comes due over the next few years. While we currently believe we will have the financial resources to meet our obligations when they come due, we cannot anticipate what our or QCII's future condition will be. We may have unexpected costs and liabilities and we may have limited access to financing.

In addition to our periodic need to obtain financing in order to meet our debt obligations as they come due, we may also need to obtain additional financing or investigate other methods to generate cash (such as further cost reductions or the sale of assets) if cash provided by our and QCII's operations does not improve, if revenue and cash provided by operations decline, if economic conditions weaken, if competitive pressures increase or if we or QCII become subject to significant judgments and/or settlements as further discussed in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report and in "Liquidity and Capital Resources" above. We can give no assurance that such additional financing will be available on terms that are acceptable. Also, we may be impacted by factors relating to or affecting QCII's liquidity and capital resources due to perception in the market, impacts on credit ratings, or provisions in our and QCII's financing agreements that may restrict our flexibility under certain conditions. The 2004 QSC Credit Facility has a cross payment default provision, and the 2004 QSC Credit Facility and certain other debt issues of QCII and its other subsidiaries have cross acceleration provisions. When present, such provisions could have a wider impact on liquidity than might otherwise arise from a default or acceleration of a single debt instrument. As a wholly owned subsidiary of QCII and QSC, any such event could adversely affect our ability to conduct business or access the capital markets and could adversely impact our credit ratings.

In addition, the 2004 QSC Credit Facility contains various limitations, including a restriction on using any proceeds from the facility to pay settlements or judgments relating to the investigation and securities actions discussed in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report.

Our high debt levels could adversely impact our credit ratings. Additionally, the degree to which we, together with QCII, are leveraged may have other important limiting consequences, including the following:

- placing us at a competitive disadvantage as compared with our less leveraged competitors, including some who have significantly reduced their debt through a bankruptcy proceeding;
- making us more vulnerable to the current or future downturns in general economic conditions or in any of our businesses;

- limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate; and
- impairing our ability to obtain additional financing in the future for working capital, capital expenditures or general corporate purposes.

***We may be unable to significantly reduce the substantial capital requirements or operating expenses necessary to continue to operate our business, which may in turn affect our operating results.***

We anticipate that our capital requirements relating to maintaining and routinely upgrading our network will continue to be significant in the coming years. We may be unable to further significantly reduce our capital requirements or operating expenses even if revenue is decreasing. We also may be unable to significantly reduce the operating expenses associated with our future contractual cash obligations, including future purchase commitments, which may in turn affect our operating results. Such non-discretionary capital outlays and operating expenses may lessen our ability to compete with other providers who face less significant spending requirements. While we believe that our current level of capital expenditures will meet both our maintenance and our core growth requirements going forward, this may not be the case if circumstances underlying our expectations change.

***Declines in the value of QCII's pension plan assets could require it to provide significant amounts of funding for its pension plan.***

While QCII does not expect to be required to make material cash contributions to its defined benefit pension plan in the near term based upon current actuarial analyses and forecasts, a significant decline in the value of pension plan assets in the future or unfavorable changes in laws or regulations that govern pension plan funding could materially change the timing and amount of required pension funding. As a result, QCII may be required to fund its benefit plans with cash from operations, perhaps by a material amount. As of December 31, 2004, QCII's plan assets exceed its accumulated benefit obligation by \$475 million. Recognition of an additional minimum liability caused by changes in plan assets or measurement of the accumulated benefit obligation could have a material impact on its consolidated balance sheet. As an example, if its accumulated benefit obligation exceeded plan assets in the future, the impact would be to eliminate its prepaid pension asset, which was \$1.192 billion as of December 31, 2004, and record a pension liability for the amount that its accumulated benefit obligation exceeds plan assets with a corresponding charge to other comprehensive loss in stockholder's deficit. Alternatively, QCII could make a voluntary contribution to the plan so that the plan assets exceed the accumulated benefit obligation.

***The cash needs of our affiliated companies consume a significant amount of the cash we generate.***

We have declared and paid dividends to our direct parent, QSC, based on the earnings of our wireline operations. In July 2004, we modified our dividend practice to balance our financial needs, cash position and credit profile with those of our parent. As a result, going forward, we may declare and pay dividends in excess of our earnings to the extent permitted by applicable law, which may consume a significant amount of the cash we generate. Our debt covenants do not limit the amount of dividends we can pay to our parent.

***The debt agreements of QCII and Qwest will allow each to incur significantly more debt, which could exacerbate the other risks described herein.***

The terms of QCII's and our debt instruments permit both QCII and us to incur additional indebtedness. Such debt may be necessary to comply with regulatory obligations to maintain QCII's or our assets, to satisfy regulatory service obligations, to adequately respond to competition or for financial reasons alone. Incremental borrowings or borrowings at maturity on terms that impose

additional financial risks to our various efforts to improve our financial condition and results of operations could exacerbate the other risks described herein.

### **Other Risks Relating to Qwest**

*If conditions or assumptions differ from the judgments, assumptions or estimates used in our critical accounting policies, the accuracy of our financial statements and related disclosures could be affected.*

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States, or GAAP, requires management to make judgments, assumptions and estimates that affect the amounts reported in our consolidated financial statements and accompanying notes. Our critical accounting policies, which are described in our Annual Report on Form 10-K for the year ended December 31, 2004, or our 2004 Form 10-K, describe those significant accounting policies and methods used in the preparation of our consolidated financial statements that are considered "critical" because they require judgments, assumptions and estimates that materially impact our consolidated financial statements and related disclosures. As a result, if future events differ significantly from the judgments, assumptions and estimates in our critical accounting policies or different assumptions are used in the future, such events or assumptions could have a material impact on our consolidated financial statements and related disclosures.

*Taxing authorities may determine we owe additional taxes relating to various matters, which could adversely affect our financial results.*

As a significant taxpayer, QCII is subject to frequent and regular audits from the IRS, as well as from state and local tax authorities. These audits could subject us to risks due to adverse positions that may be taken by these tax authorities. Please see Note 6—Commitments and Contingencies—Other Matters to our condensed consolidated financial statements in Item 1 of Part I of this report for examples of legal proceedings involving some of these adverse positions. For example, in the fourth quarter of 2004, QCII received notices of proposed adjustments on several significant issues for the 1998-2001 audit cycle. Additionally, the IRS indicated in January 2005, that it is reviewing QCII's tax treatment of the sale of its DEX directory publishing business in the 2002-2003 audit cycle.

Because prior to 1999 QCII was a member of affiliated groups filing consolidated U.S. federal income tax returns, QCII could be severally liable for tax examinations and adjustments not directly applicable to current members of the Qwest affiliated group. Tax sharing agreements have been executed between QCII and previous affiliates, and QCII believes the liabilities, if any, arising from adjustments to tax liability would be borne by the affiliated group member determined to have a deficiency under the terms and conditions of such agreements and applicable tax law. QCII has not provided in its financial statements for any liability of former affiliated members or for claims they have asserted or may assert against QCII.

While QCII believes its tax reserves adequately provide for the associated tax contingencies under current accounting literature, QCII's tax audits and examinations may result in tax liabilities that differ materially from those it has recorded in its consolidated financial statements. Also, the ultimate outcomes of all of these matters are uncertain, and QCII can give no assurance as to whether an adverse result from one or more of them will have a material effect on its financial results, including potentially offsetting a significant portion of its existing net operating losses, which could affect our financial condition and operating results to the extent the matters affect us.

***If we fail to extend or renegotiate our collective bargaining contracts with our labor unions as they expire from time to time, or if our unionized employees were to engage in a strike or other work stoppage, our business and operating results could be materially harmed.***

We are a party to collective bargaining contracts with our labor unions, which represent a significant number of our employees. Although we believe that our relations with our employees are satisfactory, no assurance can be given that we will be able to successfully extend or renegotiate our collective bargaining agreements as they expire from time to time. If we fail to extend or renegotiate our collective bargaining agreements, if disputes with our unions arise, or if our unionized workers engage in a strike or other work stoppage, we could incur higher ongoing labor costs or experience a significant disruption of operations, which could have a material adverse effect on our business. In August 2003, we reached agreements with the Communications Workers of America, or CWA, and the International Brotherhood of Electrical Workers, or IBEW, on two-year labor contracts. Each of these agreements was ratified by union members and expires on August 13, 2005. The impact of the 2005 and future negotiations, including changes in wages and benefit levels, including, but not limited to, the cost of providing active and post-retirement healthcare, could have a material impact on our financial results.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information under the caption "Risk Management" in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 2 of Part I of this report is incorporated herein by reference.

### **ITEM 4. CONTROLS AND PROCEDURES**

The effectiveness of our or any system of disclosure controls and procedures is subject to certain limitations, including the exercise of judgment in designing, implementing and evaluating the controls and procedures, the assumptions used in identifying the likelihood of future events, and the inability to eliminate misconduct completely. As a result, there can be no assurance that our disclosure controls and procedures will detect all errors or fraud. By their nature, our or any system of disclosure controls and procedures can provide only reasonable assurance regarding management's control objectives.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, or the "Exchange Act") as of June 30, 2005. On the basis of this review, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures are designed, and are effective, to give reasonable assurance that the information required to be disclosed by us in reports that we file under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and to ensure that information required to be disclosed in the reports filed or submitted under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, in a manner that allows timely decisions regarding required disclosure.

There were no changes in our internal control over financial reporting that occurred in the second quarter of 2005 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II—OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The information contained in Note 6—Commitments and Contingencies to our condensed consolidated financial statements in Item 1 of Part I of this report is hereby incorporated by reference.

### ITEM 6. EXHIBITS

Exhibits filed for Qwest through the filing of this Form 10-Q:

Exhibits identified in parentheses below are on file with the SEC and are incorporated herein by reference. All other exhibits are provided as part of this electronic submission.

Exhibit Number	Description
(3.1)	Restated Articles of Incorporation of Qwest (incorporated by reference to Qwest's Annual Report on Form 10-K for the year ended December 31, 1997, File No. 1-3040.)
(3.2)	Articles of Amendment to the Articles of Incorporation of Qwest (incorporated by reference to Qwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000, File No. 1-3040.)
(3.3)	Amended and Restated Bylaws of Qwest (incorporated by reference to Qwest's Annual Report on Form 10-K/A for the year ended December 31, 2002, File No. 1-3040.)
(4.1)	Indenture, dated as of April 15, 1990, by and between Mountain States Telephone and Telegraph Company and The First National Bank of Chicago (incorporated by reference to Qwest's Annual Report on Form 10-K/A for the year ended December 31, 2002, File No. 1-3040.)
(4.2)	First Supplemental Indenture, dated as of April 16, 1991, by and between U S WEST Communications, Inc. and The First National Bank of Chicago (incorporated by reference to Qwest's Annual Report on Form 10-K/A for the year ended December 31, 2002, File No. 1-3040.)
(4.3)	Indenture, dated as of October 15, 1999, by and between U S WEST Communications, Inc. and Bank One Trust Company, N.A. (incorporated by reference to Qwest's Annual Report on Form 10-K for the year ended December 31, 1999, File No. 1-3040.)
(4.4)	Officer's Certificate of Qwest, dated March 12, 2002 (including forms of 8 <sup>7</sup> / 8 % notes due March 15, 2012) (incorporated by reference to Qwest's Form S-4, File No. 333-115119.)
(4.5)	First Supplemental Indenture, dated as of August 19, 2004, by and between Qwest and U.S. Bank N.A. (incorporated by reference to Qwest Communications International Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, File No. 1-15577.)
(4.6)	Second Supplemental Indenture, dated as of November 23, 2004, by and between Qwest and U.S. Bank N.A. (incorporated by reference to Qwest's Current Report on Form 8-K filed November 23, 2004, File No. 001-03040.)
(4.7)	Third Supplemental Indenture, dated as of June 17, 2005, by and between Qwest Corporation and U.S Bank National Association (incorporated by reference to Qwest's Current Report on Form 8-K filed on June 23, 2005, File No. 001-03040).

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|--------|---|
| (10.1) | Registration Rights Agreement, dated August 19, 2004, by and among Qwest Corporation and the initial purchasers listed therein (incorporated by reference to Qwest Communications International Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, File No. 1-15577.) |
| (10.2) | Registration Rights Agreement, dated November 23, 2004, by and among Qwest and the initial purchasers listed therein (incorporated by reference to Qwest's Current Report on Form 8-K filed November 18, 2004, File No. 001-03040.)   |

- (10.3) Registration Rights Agreement, dated June 17, 2005, among Qwest Corporation and the initial purchasers listed therein (incorporated by reference to Qwest's Current Report on Form 8-K filed on June 23, 2005, File No. 001-03040).
  - 12 Calculation of Ratio of Earnings to Fixed Charges.
  - 31.1 Chief Executive Officer Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 31.2 Chief Financial Officer Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
  - 32 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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( ) Previously filed.

In accordance with Item 601(b)(4)(iii)(A) of Regulation S-K, copies of certain instruments defining the rights of holders of certain of our long-term debt are not filed herewith. Pursuant to this regulation, we hereby agree to furnish a copy of any such instrument to the SEC upon request.

## **SIGNATURE**

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

### **QWEST CORPORATION**

By:

/s/ JOHN W. RICHARDSON

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John W. Richardson  
*Senior Vice President and Controller*  
*(Duly Authorized Officer and Chief Accounting Officer)*

August 2, 2005





**QWEST CORPORATION**  
**CALCULATION OF RATIO OF EARNINGS TO FIXED CHARGES**  
**(DOLLARS IN MILLIONS)**

	Six Months Ended June 30, 2005	Years Ended December 31,				
		2004	2003	2002	2001	2000
Income from continuing operations before income taxes, discontinued operations and cumulative effect of change in accounting principle effect	\$ 824	\$ 1,742	\$ 1,758	\$ 2,435	\$ 2,833	\$ 2,203
Add: estimated fixed charges	328	647	643	634	588	588
Add: estimated amortization of capitalized interest	6	10	13	14	15	12
Less: interest capitalized	(3)	(9)	(13)	(24)	(44)	(49)
Total earnings available for fixed charges	1,155	2,390	2,401	3,059	3,392	2,754
Estimate of interest factor on rentals	25	54	57	69	79	81
Interest expense, including amortization of premiums, discounts and debt issuance costs	300	584	573	541	465	458
Interest capitalized	3	9	13	24	44	49
Total fixed charges	\$ 328	\$ 647	\$ 643	\$ 634	\$ 588	\$ 588
Ratio of earnings to fixed charges	3.5	3.7	3.7	4.8	5.8	4.7

Until May 1, 2004, Qwest Corporation provided wireless services through its wholly owned subsidiary, Qwest Wireless LLC ("Qwest Wireless"). On May 1, 2004, we transferred ownership of Qwest Wireless to an affiliate. As a consequence, we no longer have wireless operations, and the results of operations and the financial position of Qwest Wireless have been reclassified in our consolidated financial statements to be included in discontinued operations. Amounts shown in this schedule have also been revised to conform to the current presentation of our consolidated financial statements.

QWEST CORPORATION CALCULATION OF RATIO OF EARNINGS TO FIXED CHARGES (DOLLARS IN MILLIONS)

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER**

I, Richard C. Notebaert, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Qwest Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 2, 2005

/s/ RICHARD C. NOTEBAERT

Richard C. Notebaert  
*Chairman, Chief Executive Officer and President*

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Exhibit 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Oren G. Shaffer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Qwest Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 2, 2005

/s/ OREN G. SHAFFER

Oren G. Shaffer  
*Vice Chairman and Chief Financial Officer*

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Exhibit 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER

**CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER CERTIFICATION**

Each of the undersigned hereby certifies, for the purposes of section 1350 of chapter 63 of title 18 of the United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, in his capacity as an officer of Qwest Corporation ("Qwest"), that, to his knowledge, the Quarterly Report of Qwest on Form 10-Q for the quarter ended June 30, 2005, fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934 and that the information contained in such report fairly presents, in all material respects, the financial condition and results of operation of Qwest. This written statement is being furnished to the Securities and Exchange Commission as an exhibit to such Form 10-Q. A signed original of this statement has been provided to Qwest and will be retained by Qwest and furnished to the Securities and Exchange Commission or its staff upon request.

Dated: August 2, 2005

By: /s/ RICHARD C. NOTEBAERT

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Richard C. Notebaert  
*Chairman, Chief Executive Officer and President*

Dated: August 2, 2005

By: /s/ OREN G. SHAFFER

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Oren G. Shaffer  
*Vice Chairman and Chief Financial Officer*

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QuickLinks

Exhibit 32

CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER CERTIFICATION