Depreciation and amortization expenses decreased $333, or 4.5%, in 2005 and $309, or 4.0%, in 2004. Lower expenses in 2005 and 2004 were due primarily to significantly lower capital expenditure levels since 2001.

AT&T Corp.
Segment Results

	2005	2004	2003
Segment operating revenues			
Voice	$ 361	$ —	$ —
Data	1,129	—	—
Long-distance voice	1,208	—	—
Other	189	—	—
Total Segment Operating Revenues	2,887	—	—
Segment operating expenses			
Cost of sales	1,686	—	—
Selling, general and administrative	669	—	—
Depreciation and amortization	414	—	—
Total Segment Operating Expenses	2,769	—	—
Segment Operating Income	118	—	—
Equity in Net Income of Affiliates	2	—	—
Segment Income	$ 120	$ —	$ —

The AT&T Corp. segment consists of the results of ATTC after we completed our acquisition on November 18, 2005. Our AT&T Corp. segment operating income margin was 4.1% for the 43-day period ended December 31, 2005. The results included the effects of the purchase accounting rules required under GAAP. The discussion below includes our understanding of the trends of the business prior to and following the November acquisition.

Voice revenues of $361 for the period have been negatively impacted by ATTC's 2004 decision to shift emphasis away from residential customer acquisitions as a result of changes in the federal regulatory environment over the past two years. For these changes, see the "Regulatory Developments" section.

Data revenues of $1,129 have been negatively impacted by competitive pricing pressure. Positively impacting data revenue were advanced services, such as Enhanced Virtual Private Network and IP-enabled frame relay services.

Long-distance voice revenues of $1,208 have been negatively impacted by competition, which has led to lower prices in business markets and loss of consumer and small- and medium-sized business market share, and substitution which has led to lower volumes.

Other operating revenues of $189 have been negatively impacted by contract terminations and renegotiations.

Cost of sales of $1,686 includes the costs of operating and maintaining the network, as well as traffic compensation expense. Traffic compensation expense was approximately $1,102, or 65%, of total costs of sales.

Selling, general and administrative expenses of $669 include our provision for uncollectible accounts and sales and marketing functions.

Depreciation and amortization expenses of $414 included amortization expense of $192 associated with acquired intangible assets, of which $184 was from customer-related intangibles.

Supplemental Information
To provide improved comparability versus previous quarters, below is a supplemental table providing quarterly pro forma operating revenues of the AT&T Corp. segment. On a pro forma operating revenue basis, this segment would have represented 26% of total segment operating revenues for 2005 (segment operating revenues include 100% of our Cingular segment operating revenues).

AT&T Corp.
Pro Forma Segment Operating Revenues

	Three-Month Period Ended			
	Dec 31, 2005	Sep 30, 2005	Jun 30, 2005	Mar 31, 2005
AT&T Corp. Operating Revenues	$3,481[1]	$6,620	$6,760	$7,015
AT&T Corp. Segment Operating Revenues	2,887[2]	—	—	—
Pro Forma AT&T Corp. Segment Operating Revenues	**$6,368**	**$6,620**	**$6,760**	**$7,015**

[1]AT&T Corp. results from October 1, 2005 – November 18, 2005.
[2]AT&T Corp. segment results from November 19, 2005 – December 31, 2005.

Revenues from business customers declined during 2005 reflecting continued pricing pressures in traditional voice and data products, offset in part by growth in IP-based products and E-services. Revenues from consumer (residential and small- and medium-sized businesses) customers declined during 2005 reflecting industry trends and ATTC's decision (prior to the acquisition) to shift its emphasis to other segments of the business.

Dollars in millions except per share amounts

Cingular
Segment Results

				Percent Change[1]	
	2005	2004	2003	2005 vs. 2004	2004 vs. 2003
Segment operating revenues					
Service	$30,638	$17,602	$14,317	—	22.9%
Equipment	3,795	1,963	1,260	—	55.8
Total Segment Operating Revenues	34,433	19,565	15,577	—	25.6
Segment operating expenses					
Cost of services and equipment sales	14,387	7,611	5,806	—	31.1
Selling, general and administrative	11,647	7,349	5,428	—	35.4
Depreciation and amortization	6,575	3,077	2,089	—	47.3
Total Segment Operating Expenses	32,609	18,037	13,323	—	35.4
Segment Operating Income	1,824	1,528	2,254	19.4	(32.2)
Interest Expense	1,260	900	856	40.0	5.1
Equity in Net Income (Loss) of Affiliates	5	(415)	(333)	—	(24.6)
Other – net	(38)	(70)	(60)	45.7	(16.7)
Segment Income	$ 531	$ 143	$ 1,005	—	(85.8)%

[1]Cingular's 2005 operating revenue and expense percentage increases and decreases are not considered meaningful due to Cingular's fourth-quarter 2004 acquisition of AT&T Wireless and are denoted with a dash.

Accounting for Cingular

We account for our 60% economic interest in Cingular under the equity method of accounting in our consolidated financial statements since we share control equally (i.e., 50/50) with our 40% economic partner BellSouth in the joint venture. We have equal voting rights and representation on the Board of Directors that controls Cingular. This means that our consolidated results include Cingular's results in the "Equity in net income of affiliates" line. However, when analyzing our segment results, we evaluate Cingular's results on a stand-alone basis using information provided by Cingular during the year. Accordingly, in our segment presentation, we present 100% of Cingular's revenues and expenses under "Segment operating revenues" and "Segment operating expenses." Including 100% of Cingular's results in our segment operations (rather than 60% in equity in net income of affiliates) affects the presentation of this segment's revenues, expenses, operating income, nonoperating items and segment income but does not affect our consolidated net income. We discuss Cingular's liquidity and capital expenditures under the heading "Cingular" within the "Liquidity and Capital Resources."

In the first quarter of 2005, to be consistent with industry practices, Cingular changed its income statement presentation for the current and prior-year periods to record billings to customers for various state gross receipts taxes and other fees as "Service" revenues and the taxes assessed by the various state jurisdictions and other fees as "Cost of services and equipment sales." This amount totaled approximately $129 in 2004 and $94 in 2003. Operating income and net income for all restated periods were not affected.

Acquisition of AT&T Wireless

On October 26, 2004, Cingular acquired AT&T Wireless for approximately $41,000 in cash. We and BellSouth funded, by means of an equity contribution to Cingular, a significant portion of the acquisition's purchase price. Based on our 60% equity ownership of Cingular, and after taking into account cash on hand at AT&T Wireless, we provided approximately $21,600 to fund the purchase price. Equity ownership and management control of Cingular remains unchanged after the acquisition.

In the first half of 2005, Cingular completed all required divestitures of assets and spectrum in certain markets in response to the agreement made with the U.S. Department of Justice (DOJ) and the FCC as a condition to receiving regulatory approval to acquire AT&T Wireless. These required divestitures included Cingular's sale of certain former AT&T Wireless assets and properties, including licenses, network assets and subscribers that Cingular operated in several markets.

In October 2005, Cingular approved the final phase of its network integration plan. This phase will involve integrating its Global System for Mobile Communication (GSM) networks, decommissioning redundant cell sites and core network elements, and swapping vendor equipment in various markets in order to have similar equipment in each market. Cingular expects to complete its network integration plan by the end of 2006 and to incur costs of approximately $580 related to this phase of its plan, which includes integration exit cost liabilities of $350 that were recorded as an adjustment to the AT&T Wireless purchase price allocation. In connection with the approval of this final phase, Cingular reduced its network equipment balance by approximately $60 for equipment removed from service during 2005. Although Cingular will be decommissioning much of its Time Division Multiple Access (TDMA) network it will continue providing analog services to some customers through February 2008.

Cingular's Customer and Operating Trends

As of December 31, 2005, Cingular served approximately 54.1 million cellular/PCS (wireless) customers, compared to 49.1 million at December 31, 2004 and 24.0 million at December 31, 2003. Cingular's increase in customer gross additions was primarily due to the acquisition of AT&T Wireless in late October 2004. The increase was also due to Cingular's larger distribution network, its broad range of service offerings and increased advertising. Cingular's recent customer activity is listed below:

Wireless Customer Activity

	Three-Month Period Ended				
(in 000s)	Dec 31, 2005	Sep 30, 2005	Jun 30, 2005	Mar 31, 2005	Dec 31, 2004
Gross additions	**5,136**	4,386	4,292	4,672	4,914
Net additions	**1,820**	867	952	1,367	1,699
Other adjustments[1]	**32**	(17)	140	(149)	21,761
Net additions including other adjustments[1]	**1,852**	850	1,092	1,218	23,460

[1]Other adjustments include customers gained or lost through property divestitures related to the AT&T Wireless acquisition and other adjustments. In the fourth quarter of 2004, other adjustments included approximately 21.9 million subscribers related to Cingular's acquisition of AT&T Wireless.

Competition and the slowing rate of new wireless users as the wireless market matures will continue to adversely impact Cingular's gross additions and revenue growth, increase expenses and put pressure on margins. Cingular expects that future revenue growth will become increasingly dependent on minimizing customer turnover (customer churn) and increasing average revenue per user/customer (ARPU). Cingular's ARPU has weakened over the past several years as it has offered a broader array of plans to expand its customer base and responded to increasing competition, resulting in pricing reductions. While Cingular's ARPU has somewhat stabilized recently, Cingular nevertheless expects continued pressure on ARPU notwithstanding increasing revenue from data services. Cingular expects its cost of services to continue increasing due to higher network system usage, including the costs Cingular is now paying T-Mobile USA (T-Mobile) for the use of its network in California and Nevada, higher costs as Cingular continues to integrate AT&T Wireless' network and operations, and, to a lesser extent, increased expenses related to operating, maintaining and decommissioning TDMA networks that duplicated GSM networks while integrating the networks acquired from AT&T Wireless. Cingular's remaining purchase commitment to T-Mobile was approximately $520 at December 31, 2005. Operating costs will substantially increase in the event that Cingular's network expansion in California and Nevada is not completed prior to fulfilling the purchase commitment with T-Mobile.

ARPU declined 0.1% in 2005 and 3.9% in 2004. The decline in ARPU was due to a decrease in local service and net roaming revenue per customer partially offset by an increase in average data revenue per customer and increased long-distance revenue per customer. Local service revenue per customer declined primarily due to customer shifts to all-inclusive rate plans that offer lower monthly charges and "rollover" minutes (which allow customers to carry over unused minutes from month to month for up to one year) as well as Cingular's free mobile-to-mobile plans, which allow Cingular customers to call other Cingular customers at no charge. An increase in customers on rollover plans tends to lower average monthly revenue per customer since unused minutes (and associated revenue) are deferred until subsequent months for up to one year.

The effective management of wireless customer churn is critical to Cingular's ability to maximize revenue growth and maintain and improve margins. Cingular's wireless customer churn rate is calculated by dividing the aggregate number of wireless customers (prepaid and postpaid) who cancel service during each month in a period by the total number of wireless customers at the beginning of each month in that period. Cingular's churn rate was 2.2% in 2005, down from 2.7% in 2004 and 2003.

The churn rate for Cingular's postpaid customers was 1.9% in 2005, down from 2.3% in 2004 and 2003. The decline in postpaid churn reflects benefits from the acquisition of AT&T Wireless, including more affordable rate plans, broader network coverage, higher network quality, exclusive devices and free mobile-to-mobile calling among Cingular's 54.1 million customers.

The decline in Cingular's churn rate compared to 2004 resulted primarily from a change in methodology of calculating churn related to reseller customers. Beginning in the first quarter of 2005, Cingular adopted a new reseller churn calculation methodology that resulted in an aggregate churn calculation that is more comparable with its major competitors. Prior to 2005, Cingular included gross reseller disconnects in its churn calculation. Effective with the first quarter of 2005, Cingular's churn calculation is based on total net reseller disconnects. This change resulted in an improvement to 2005 reported churn of approximately 32 basis points. Partially offsetting Cingular's churn decline was an increase in prepaid customer churn.

Cingular's Operating Results

Our Cingular segment operating income margin was 5.3% in 2005, 7.8% in 2004 and 14.5% in 2003. The lower margins in 2005 and 2004 compared to 2003 were caused by expenses increasing at a higher rate than revenues, which was primarily attributable to the acquisition of AT&T Wireless in late October 2004. However, our Cingular segment operating income margin improved every quarter during 2005 compared to the fourth quarter of 2004. Cingular's operating income margin was 6.2% in the fourth quarter of 2005, 7.5% in the third quarter, 5.9% in the second quarter and 1.4% in the first quarter of 2005 compared to an operating loss margin of 2.1% in the fourth quarter of 2004.

Cingular's operating expenses increased $14,572 in 2005 and $4,714 in 2004. More than offsetting these operating expenses was revenue growth of $14,868 in 2005. In 2004, revenue growth of $3,988 partially offset the increased operating expenses.

Service revenues are comprised of local voice and data services, roaming, long-distance and other revenue. Offsetting 2005 Service revenues was approximately $31 in customer bill credits issued to customers affected by hurricanes. Service revenues increased $13,036 in 2005 and $3,285 in 2004 and consisted of:

- Local voice revenues, which increased approximately $10,219 in 2005 and $2,741 in 2004 primarily due to the acquisition of AT&T Wireless (due to Cingular's significant increase in average number of wireless customers). Increased Universal Service Fund (USF) and regulatory compliance fees also contributed to the local voice revenues increase in 2005 and 2004.
- Data service revenues, which increased $1,785 in 2005 and $438 in 2004 primarily due to the inclusion of former AT&T Wireless customers (who on average were heavier data users than Cingular customers), increased average data revenue per customer and increased use of text messaging services. Data service revenues represented approximately 7.8% of Cingular's total revenues in 2005 and 4.6% in 2004.
- Roaming revenues from Cingular customers and other wireless carriers for use of Cingular's network, which increased $655 in 2005 and $6 in 2004. The 2005 increase was primarily due to roaming revenues from the acquired AT&T Wireless customer base.
- Long-distance and other revenue, which increased $377 in 2005 and $100 in 2004 primarily due to increased long-distance revenues from the acquired AT&T Wireless customer base as well as increased domestic and international long-distance calling.

Equipment revenues increased $1,832 in 2005 and $703 in 2004 due to increased handset revenues primarily as a result of significantly higher gross customer additions and increases in existing customers upgrading their units. Upgrade unit sales reflect an increase in GSM upgrades and Cingular's efforts to migrate former AT&T Wireless customers to Cingular service offerings.

Cost of services and equipment sales expenses increased $6,776 in 2005 and $1,805 in 2004 primarily due to increased cost of services resulting from incremental costs related to the acquired AT&T Wireless network. Included in the 2005 increase were integration costs of approximately $195 related to the acquired AT&T Wireless network and hurricane-related costs of $97.

Cost of services increased $4,581 in 2005 and $962 in 2004. Cost of services increased due to the following:

- Increases in network usage with a minutes of use increase of more than 110% in 2005 and more than 50% in 2004 primarily due to the increase in subscribers related to Cingular's acquisition of AT&T Wireless.
- Increased costs Cingular is now paying T-Mobile for the use of its network in California and Nevada.
- Increased expenses related to operating, maintaining and decommissioning TDMA networks that duplicated GSM networks while integrating the networks acquired from AT&T Wireless.
- Higher roaming and long-distance cost and increased USF and regulatory fees related to the increase in the customer base.

Equipment sales expense increased $2,195 in 2005 and $843 in 2004 primarily due to higher handset unit sales associated with the 46.1% increase in gross customer additions in 2005 and more than 30.0% in 2004, existing customers upgrading their units and the continued migration of former AT&T Wireless customers to Cingular service offerings. Equipment costs increased at a higher rate than equipment revenues due to Cingular's sales of handsets below cost, through direct sales sources, to customers who committed to one-year or two-year contracts or in connection with other promotions.

Selling, general and administrative expenses increased $4,298 in 2005 and $1,921 in 2004 primarily due to incremental expenses associated with the acquisition of AT&T Wireless. These increases include integration costs of approximately $264 in 2005 and $277 in 2004, including employee termination costs, re-branding and advertising of the Cingular and AT&T Wireless combination and customer service and systems integration costs. Also included in this increase were hurricane-related costs of $19 in 2005.

Total selling expenses increased $1,385 in 2005 and $873 in 2004 primarily due to the increase in gross customer additions previously mentioned. Total selling expenses include sales, marketing, advertising and commissions expense. Cingular's sales expense increased approximately $462 in 2005 and $232 in 2004 primarily due to increased sales personnel costs associated with the acquired AT&T Wireless sales force. Commissions expense increased approximately $494 in 2005 and $289 in 2004 and advertising and marketing expenses increased $429 in 2005 and $352 in 2004.

General and administrative expenses increased $2,913 in 2005 and $1,048 in 2004 primarily due to the previously mentioned incremental expenses from AT&T Wireless and integration costs. General and administrative expenses include customer service, upgrade commissions, billing, bad debt, other maintenance and other administrative expense. Customer service expenses increased approximately $960 in 2005 and $395 in 2004 due to a higher number of employees and employee-related expenses related to the significant increase in customers, as well as customer retention and customer service improvement initiatives. Other administrative expenses increased approximately $926 in 2005 and $307 in 2004 primarily due to incremental expenses associated with the acquired AT&T Wireless administrative functions. Billing, bad debt and other customer maintenance expense increased approximately $766 in 2005 and $305 in 2004 primarily due to the significant increase in Cingular's customer base. Upgrade commissions increased approximately $261 in 2005 and $41 in 2004 due to the previously mentioned increased customer migration and handset upgrade activity.

Depreciation and amortization expenses increased $3,498 in 2005 and $988 in 2004. These increases include approximately $417 of integration costs in 2005. Depreciation expense increased approximately $2,249 in 2005 and $635 in 2004 primarily due to incremental depreciation associated with the property, plant and equipment acquired in the AT&T Wireless acquisition and depreciation related to Cingular's ongoing capital spending associated with its GSM network. Additionally, depreciation expense increased due to accelerated depreciation on certain TDMA network assets based on Cingular's projected transition of network traffic to GSM technology and accelerated depreciation on certain other network assets. Substantially all of Cingular's TDMA assets are anticipated to be fully depreciated by the end of 2007.

Amortization expense increased approximately $1,249 in 2005 and $353 in 2004 primarily due to the amortization of the AT&T Wireless customer contracts and other intangible assets acquired.

Supplemental Information

Because Cingular's acquisition of AT&T Wireless has a significant effect on comparative financial information, we have included the following sequential quarterly results for comparative purposes.

Cingular's operating margins have increased since the acquisition reflecting the continued increase in the number of wireless customers, continued progress in its merger-integration initiatives, as well as continued improvement in customer churn compared with 2004.

Cingular
Sequential Segment Results

	Three-Month Period Ended				
	Dec 31, 2005	Sep 30, 2005	Jun 30, 2005	Mar 31, 2005	Dec 31, 2004
Segment operating revenues					
Service revenues	**$7,779**	$7,721	$7,719	$7,419	$6,313
Equipment revenues	**1,070**	1,025	890	810	806
Total Segment Operating Revenues	**8,849**	8,746	8,609	8,229	7,119
Segment operating expenses					
Cost of services and equipment sales	**3,758**	3,667	3,523	3,439	2,939
Selling, general and administrative	**2,812**	2,881	2,953	3,001	2,947
Depreciation and amortization	**1,730**	1,541	1,629	1,675	1,386
Total Segment Operating Expenses	**8,300**	8,089	8,105	8,115	7,272
Segment Operating Income (Loss)	**549**	657	504	114	(153)
Interest Expense	**292**	304	326	338	303
Equity in Net Income (Loss) of Affiliates	**1**	1	1	2	(114)
Other – net	**(6)**	(28)	(8)	4	13
Segment Income (Loss)	**$ 252**	$ 326	$ 171	$ (218)	$ (557)

Directory
Segment Results

				Percent Change	
	2005	2004	2003	**2005 vs. 2004**	2004 vs. 2003
Total Segment Operating Revenues	**$3,714**	$3,759	$3,773	**(1.2)%**	(0.4)%
Segment operating expenses					
Cost of sales	**1,103**	1,022	964	**7.9**	6.0
Selling, general and administrative	**612**	622	673	**(1.6)**	(7.6)
Depreciation and amortization	**5**	9	21	**(44.4)**	(57.1)
Total Segment Operating Expenses	**1,720**	1,653	1,658	**4.1**	(0.3)
Segment Operating Income	**1,994**	2,106	2,115	**(5.3)**	(0.4)
Equity in Net Income (Loss) of Affiliates	**(5)**	—	—	**—**	—
Segment Income	**$1,989**	$2,106	$2,115	**(5.6)%**	(0.4)%

In September 2004, we sold our interest in the directory advertising business in Illinois and northwest Indiana. Our directory segment results exclude the results of those operations (see Note 17). In November 2004, our directory segment entered into a joint venture agreement with BellSouth and acquired the internet directory publisher, YPC. We account for YPC under the equity method of accounting.

Our directory segment operating income margin was 53.6% in 2005, 56.0% in 2004 and 56.1% in 2003. The segment operating income margin decrease in 2005 is a result of both higher expenses and lower revenues. The segment operating income margin stability in 2004 is due to our revenues and expenses for both periods being relatively flat.

Dollars in millions except per share amounts

Operating revenues decreased $45, or 1.2%, in 2005 and $14, or 0.4%, in 2004. The decrease in revenues in 2005 was primarily due to a decrease of approximately $74 in our local Yellow Pages advertising, which was partially offset by an increase of $39 in internet advertising revenue. Revenues in 2004 decreased primarily in our local Yellow Pages advertising, which decreased approximately $95 in 2004, and was partially offset by an increase of $30 in internet advertising revenue and an improvement of $27 in revenue adjustments related to customer satisfaction. These results reflect the impact of competition from other publishers, other advertising media and continuing economic pressures on advertising customers.

Cost of sales increased $81, or 7.9%, in 2005 and $58, or 6.0%, in 2004. The increase in 2005 was primarily driven by higher costs for internet traffic of approximately $22, publishing of $17 and distribution of $9. In 2004, cost of sales increased due to higher costs for commissions, publishing and distribution which were partially offset by decreased costs for paper and printing.

Selling, general and administrative expenses decreased $10, or 1.6%, in 2005 and $51, or 7.6%, in 2004. The expense reduction in 2005 was primarily due to lower advertising expense. Decreased expenses in 2004 were primarily due to lower uncollectible expense of approximately $68, partially offset by increases in advertising expense of $25 and increased employee benefit-related costs of $14.

International
Segment Results

				Percent Change	
	2005	2004	2003	**2005 vs. 2004**	2004 vs. 2003
Total Segment Operating Revenues	**$ 10**	$ 22	$ 30	**(54.5)%**	(26.7)%
Total Segment Operating Expenses	**28**	31	47	**(9.7)**	(34.0)
Segment Operating Income (Loss)	**(18)**	(9)	(17)	**—**	47.1
Equity in Net Income of Affiliates	**395**	812	606	**(51.4)**	34.0
Segment Income	**$377**	$803	$589	**(53.1)%**	36.3%

Our international segment consists primarily of equity investments in international companies, the income from which we report as equity in net income of affiliates. Revenues from the segment's direct international operations are less than 1% of our consolidated revenues.

Our earnings from foreign affiliates are sensitive to exchange-rate changes in the value of the respective local currencies. See Note 1 for a discussion of foreign currency translation. Our foreign investments are recorded under GAAP, which include adjustments for the purchase method of accounting and exclude certain adjustments required for local reporting in specific countries. In discussing Equity in Net Income of Affiliates, all dollar amounts refer to the effect on our income. The following table summarizes the individual results for our significant equity holdings in the international segment. A discussion of these results follows. See "Other income (expense) – net" and Note 2 for information on the sale of several investments during 2004.

Segment operating revenues decreased $12, or 54.5%, in 2005 and $8, or 26.7%, in 2004. Revenues declined primarily due to forgone management-fee revenues from the disposition of investments.

Segment operating expenses decreased $3, or 9.7%, in 2005 and $16, or 34.0%, in 2004. Expenses in 2005 declined primarily due to lower employee costs resulting from fewer foreign-based employees. Expenses in 2004 declined primarily due to lower corporate-allocated charges.

Our equity in net income of affiliates by major investment at December 31, are listed below:

	2005	2004	2003
América Móvil	**$198**	$132	$ 76
Belgacom[1]	**—**	49	28
TDC[1]	**—**	328	182
Telkom South Africa[1]	**—**	115	121
Telmex	**212**	180	196
Other	**(15)**	8	3
Equity in Net Income of Affiliates	**$395**	$812	$606

[1]Investment sold in 2004.

Equity in net income of affiliates decreased $417, or 51.4%, in 2005 and increased $206, or 34.0%, in 2004. The decrease in 2005 was primarily due to gains that occurred in 2004, and foregone equity income from the disposition of investments. Increases at América Móvil and Telmex reflect better operating results at both companies and reduced income taxes at América Móvil.

The increase in 2004 was primarily due to a gain of approximately $235 from TDC, related to the sale of its interest in Belgacom. Equity income in 2004 also increased due to a settlement loss of $160 in 2003 on a transfer of pension liabilities which affected year-over-year comparisons. The settlement loss in 2003 resulted from a transfer of pension liabilities by Belgacom to the Belgian government and included a loss of approximately $115 from Belgacom and TDC's loss of $45 associated with the same transaction. Equity in net income of affiliates in 2004 also increased approximately: (1) $53 due to favorable operating results, primarily at América Móvil, (2) $46 due to prior-year restructuring charges at TDC and (3) $65 due to favorable financing and exchange-rate impacts. These increases were partially offset by lower equity income of approximately $314 related to asset sales, including: (1) $131 from the sale of our and TDC's investment in Belgacom, (2) $38 from the sale of our interest in Telkom and (3) $145 from the sale of our interest in TDC. The increases were also offset by combined charges of approximately $51 for 2004 restructuring charges at TDC and impairment of our goodwill associated with a TDC subsidiary.

Other
Segment Results

				Percent Change	
	2005	2004	2003	**2005 vs. 2004**	2004 vs. 2003
Total Segment Operating Revenues	**$253**	$244	$263	**3.7%**	(7.2)%
Total Segment Operating Expenses	**183**	64	119	**—**	(46.2)
Segment Operating Income	**70**	180	144	**(61.1)**	25.0
Equity in Net Income of Affiliates	**217**	61	647	**—**	(90.6)
Segment Income	**$287**	$241	$791	**19.1%**	(69.5)%

Our other segment results consist primarily of corporate and other operations. In November 2005, we sold our paging operations.

Segment operating revenues increased in 2005 as a result of higher revenues from capital leasing subsidiaries. Segment operating revenues decreased in 2004 as a result of lower revenues from paging and capital leasing subsidiaries.

Equity in Net Income of Affiliates primarily represents the equity income from our investment in Cingular.

OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

2006 Revenue Trends Our acquisition of ATTC will help change the focus of our company toward broadband/data and business revenues. Cingular's late-2004 acquisition of AT&T Wireless also increased our potential for growth in the wireless area. During 2005, we experienced slight growth in our traditional wireline operations and for 2006 we expect similar growth in these traditional areas. Because of the late 2005 completion date of the ATTC acquisition, we expect reported revenues to increase in 2006 compared to 2005. However, in terms of business trends, we expect our 2006 and 2007 revenues to reflect continuing but diminishing declines from ATTC operations, as we integrate their business operations. If we include our proportionate share of Cingular's revenues in analyzing our overall company prospects, we expect total year-over-year revenue growth to turn positive in 2008. Our revenue expectations assume that we will experience improvement in our retail access line trends, partially offset by a decline in the number of wholesale lines we provide, based on favorable developments in the federal regulatory environment (see the "Regulatory Developments" section). We also expect to expand services utilizing our broadband network (see "Project Lightspeed" discussed in "Expected Growth Areas") as well as the national business market as a result of the ATTC acquisition. Accordingly, we assume that we will experience continued growth in DSL and additional opportunities in the national data markets (see "Expected Growth Areas"). We also assume continued long-distance subscriber growth in our former SBC long-distance business, but at a lower rate as that long-distance business continues to mature. During the fourth quarter of 2004, Cingular completed its acquisition of AT&T Wireless and is now the largest wireless service provider in the U.S. While Cingular's revenues are not included in our consolidated revenues, we expect the increased availability and competitiveness of its service offerings will enhance our bundling opportunities (see "Cingular" discussed in "Expected Growth Areas"). However, we also expect that increasing competition in the communications industry, including the continued growth of alternative technologies such as wireless, cable and VoIP and our response to competitors' pricing strategies, as well as the trends at ATTC, will pressure revenue.

2006 Expense Trends The ATTC acquisition and related merger costs will adversely affect expenses in 2006 and 2007. We expect our operating income margin, adjusted to exclude these costs, will expand in 2008, due primarily to expected improvement in our revenues and continued cost-control measures. In particular, we expect continuing net workforce reductions over the next three years related to merger synergies and other operational initiatives. Expenses related to growth initiatives, such as Project Lightspeed (see "Expected Growth Areas"), and an expected increase in pension and other postretirement benefits costs to a range of approximately $1,700 to $1,800 will apply some pressure to our operating income margin.

OPERATING ENVIRONMENT OVERVIEW

In the Telecommunications Act of 1996 (Telecom Act), Congress established a pro-competitive, deregulatory national policy framework to bring the benefits of competition and investment in advanced telecommunications facilities and services to all Americans by opening all telecommunications markets to competition and reducing or eliminating burdensome regulation. Since the Telecom Act was passed, the FCC and state regulatory commissions have maintained many of the extensive regulatory requirements applicable to incumbent local exchange companies (ILECs), including our wireline subsidiaries, and imposed significant new regulatory requirements, including rules requiring us to unbundle our traditional network, in an effort to jump-start a specific definition of purported competition. However, over the past two years, the FCC has curtailed and, in some cases, eliminated certain of these requirements in order to promote investment and deployment of next-generation broadband services and facilities, and in response to a series of federal court decisions where the FCC's rules (in particular, those requiring ILECs to extensively unbundle their networks) exceeded the FCC's authority. For example, in February 2005, in response to a March 2004 decision by the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit), which overturned significant portions of the FCC's third set of unbundling rules, including those mandating the availability of the mass-market UNE-P, the FCC released new rules that will eliminate the requirement that our wireline subsidiaries provide the UNE-P at Total Element Long Run Incremental Cost (TELRIC) rates. Those new rules became effective March 11, 2005 and included a year-long transition for eliminating our obligation to provide mass-market UNE-P.

Additionally, on September 23, 2005, the FCC released its Title I Broadband Order (Broadband Order), which ruled that facilities-based wireline broadband internet access services offered by telephone companies are information services and should be regulated in a similar manner to broadband internet access services offered by cable companies. This order, which became effective on November 16, 2005, substantially deregulates our existing DSL services and prevents the imposition of regulation on broadband internet access services to be offered over Project Lightspeed, discussed below.

We are actively pursuing additional legislative and regulatory measures to reduce or eliminate regulatory requirements that inhibit our ability to provide the full suite of services increasingly demanded by our customers. For example, we are supporting legislative efforts at both the state and federal levels that would offer a streamlined process for new video service providers to compete with traditional cable television providers. In addition, we are supporting efforts to update regulatory treatment for retail services. As discussed in "State Regulation," Texas recently enacted legislation allowing us and other new competitors to file for a state-issued certificate of franchise authority to provide video services. The Oklahoma Corporation Commission has also issued a statewide order, which is under appeal to the Oklahoma Supreme Court by a cable provider and the AARP, that provides for increased pricing flexibility for all intrastate retail services. Other states in the 13-state area in which we operate as an ILEC are considering similar legislation. Several bills are also pending before Congress that would both reform the Telecom Act and promote additional video competition. Passage of legislation is uncertain and depends on many factors, but we believe that the increasing pace of technological change in our industry will encourage lawmakers to remove artificial barriers to competition.

Because of opportunities made available by the continued changing regulatory environment and our acquisition of ATTC, we expect that our capital expenditures in 2006 will increase to a target range of between $8,000 and $8,500. This amount includes capital for Project Lightspeed and merger-integration projects (see "Project Lightspeed" discussed in "Expected Growth Areas"). Despite a slightly more positive regulatory outlook and these broadband opportunities, increasing competition and the growth of alternative technologies such as cable, wireless and VoIP have created significant challenges for our business.

Expected Growth Areas

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

Our data services include DSL/Internet (broadband) as well as services to large businesses. At December 31, 2005, our data revenues represented approximately 30% of our consolidated revenues, and increased 18% from 2004. Our DSL lines continue to grow and were approximately 6.9 million at December 31, 2005 compared to 5.1 million at the end of 2004.

Project Lightspeed In June 2004, we announced key advances in developing a network capable of delivering a new generation of integrated digital television, super-high-speed broadband and VoIP services to our residential and small-business customers, referred to as Project Lightspeed. We have been building out this network in numerous locations and began providing services in one limited market, including IP video, in late 2005. Our goal in this controlled initial launch is to ensure that all operating and back-office systems function at a level capable of supporting our targeted mid-2006 scaled-up deployment. To that end, we have restricted the number of customers and services offered to the necessary minimum. Subject to successful results from this controlled launch and successful testing of our additional IP video services, we plan to enter additional markets in mid-2006. At that time we expect to add additional services and features to our service offerings. We expect to have the capability to offer service to approximately 18 million households by the end of 2008, as part of our initial deployment, and expect to spend approximately $4,400 in network-related deployment costs and capital expenditures beginning in 2006 through 2008, as well as additional success-based customer activation capital expenditures.

With respect to our IP video service, we continue to work with our vendors to develop, in a timely manner, the requisite hardware and software technology. Our deployment plans could be delayed if we do not receive required equipment and software on schedule. We also continue to negotiate with programming owners (e.g., movie studios and cable networks) for permission to offer existing television programs and movies and, if applicable, other new interactive services that we could offer in the future using advances in the IP technology we are testing. Our ability to provide an attractive and profitable video offering will depend in large part on the results of these efforts. Also, as discussed in the "Regulatory Developments" section, we are supporting legislation at both the federal and state levels that would streamline the regulatory process for new video competitors to enter the market.

We believe that Project Lightspeed is subject to federal oversight as a "video service" under the Federal Communications Act. Additionally, in September 2005, Texas passed a state telecommunications law that encourages new competitors to enter the video market (see "Texas Telecom Reform and Video Legislation"). However, some cable providers and municipalities have claimed that certain IP services should be treated as a traditional cable service and therefore subject to the applicable state and local regulation, which could include the requirement to pay fees to obtain local franchises for our IP video service. If the courts were to decide that state and local regulation were applicable to our Project Lightspeed services, it could have a material adverse effect on the cost, timing and extent of our deployment plans.

Wireless Cingular, our wireless joint venture with BellSouth, began operations in October 2000. In October 2004, Cingular completed its acquisition of AT&T Wireless, which established Cingular as the largest provider of mobile wireless voice and data communications services in the U.S. At December 31, 2005, Cingular served approximately 54.1 million customers and had access to licenses to provide wireless communications services covering an aggregate population of potential customers of approximately 294 million, or approximately 99% of the U.S. population, including all of the 100 largest U.S. metropolitan areas.

Cingular's wireless networks use equipment with digital transmission technologies known as GSM and TDMA technology. Cingular has upgraded its existing TDMA markets to use GSM technology in order to provide a common voice standard. Cingular is also adding high-speed wireless data services such as General Packet Radio Service (GPRS) and Enhanced Data Rates for Global Evolution (EDGE) and Universal Mobile Telecommunications System (UMTS). EDGE technology allows customers to access the Internet from their wireless devices at higher speeds than GPRS and UMTS allows for superior speed for data and video services.

We expect that intense industry competition and market saturation will likely cause the wireless industry's customer growth rate to moderate in comparison with historical growth rates. While the wireless telecommunications industry does continue to grow, a high degree of competition exists among four national carriers, their affiliates and smaller regional carriers. This competition will continue to put pressure upon pricing, margins and customer turnover as the carriers compete for potential customers. Future carrier revenue growth is highly dependent upon the number of net customer additions a carrier can achieve and the average revenue per customer. The effective management of customer turnover, or churn, is also important in minimizing customer acquisition costs and maintaining and improving margins.

Cingular faces many challenges and opportunities in the future and is focused on the following key initiatives:

- Further establishing its position as a premier provider for business and government accounts by providing these customers with access to sales and support professionals focused solely on their specialized needs.
- Continued improvement on the coverage and quality of its network. Cingular continues its process of completing the integration of the Cingular and AT&T Wireless networks under a plan that is designed to achieve network quality and coverage performance exceeding that of either of the former networks.
- Continued deployment of UMTS third-generation (3G) network technology with High-Speed Downlink Packet Access (HSDPA). UMTS and HSDPA provide superior speeds for data and video services, as well as operating efficiencies using the same spectrum and infrastructure for voice and data on an IP-based platform and will allow Cingular to offer a host of new broadband data applications.

REGULATORY DEVELOPMENTS

Set forth below is a summary of the most significant developments in our regulatory environment during 2005. While these issues, for the most part, apply only to certain subsidiaries in our wireline segment or AT&T Corp. segment, the words "we," "AT&T," "ATTC" and "our" are used to simplify the discussion. The following discussions are intended as a condensed summary of the issues rather than a precise legal description of all of those specific issues.

International Regulation ATTC subsidiaries operating outside the U.S. are subject to the jurisdiction of national regulatory authorities in the market where service is provided. Regulation is generally limited to operational licensing authority for the provision of enterprise (i.e. large business) services.

Federal Regulation A summary of significant 2005 federal regulatory developments follows.

Triennial Review Remand Order In December 2004, the FCC adopted its fourth set of rules concerning an ILEC's obligation to make elements of its network available to other local service providers. Each of its previous three sets of rules had been overturned by the federal courts. On February 4, 2005, the FCC released its written order containing the new rules, the Triennial Review Remand Order (TRRO) which became effective on March 11, 2005. The TRRO provides significant relief from unbundling by eliminating our remaining obligation to provide local switching and hence the UNE-P, for mass-market customers, subject to a 12-month transition period. At December 31, 2005, we had approximately 500,000 remaining UNE-P lines subject to the March 2006 transition deadline. Based on our marketing research, we believe that the majority of customers of those competitors who have not signed commercial UNE-P replacements or resale agreements with us have switched to alternative technologies as opposed to returning as our retail customers.

We believe, however, that the FCC's revised rules fail fully to comply with the D.C. Circuit's decision; for example, the FCC largely retained unbundling requirements for many of our high-capacity loop and transport facilities. Therefore, we (together with several other parties) filed an appeal with the D.C. Circuit challenging this portion of the TRRO. Several other parties, including competitive local exchange carriers (CLECs), filed appeals of other portions of the TRRO in other circuits. Those appeals have been consolidated in the D.C. Circuit, which is scheduled to hear oral arguments on March 21, 2006.

In addition, other parties, including CLECs, have asked the FCC to reconsider various other aspects of the FCC's order, such as extending the 12-month transition period for unbundled mass-market switching to 18 months, and modifying the unbundling analysis for high-capacity loops and dedicated transport. Specifically, the CLECs asked the FCC to change the criteria used to determine if an ILEC is required to unbundle high-capacity DS1 loops used to serve small buildings. These parties have also asked the FCC to modify or rescind that portion of the order relating to the eligibility criteria for obtaining access to combinations of unbundled high-capacity loops and transport elements (often referred to as "enhanced extended links" or EELs), which can be used as a substitute for special access services.

It is unclear how state regulatory commissions will ultimately respond to the TRRO. Under the overturned rules, state commissions had set the rates that we were allowed to charge competitors for the UNE-P and for leasing other unbundled elements of our network. Many of the states in the 13-state area in which we operate as an ILEC have opened or conducted proceedings to consider the FCC's detailed findings and transition plans outlined in the Triennial Review Order (TRO) and TRRO. Some states have taken the position that their relevant state laws have been preempted by the FCC's order and federal court decisions, while other states appear to be taking the position that their state laws have not been preempted. We expect that as the various state commissions issue rulings in these proceedings, various parties, including AT&T, will litigate some or all of these rulings.

The effects on the FCC decisions on the above topics are dependent on many factors including, but not limited to, the ultimate resolution of the pending appeals; the number and nature of competitors requesting interconnection, unbundling or resale; and the results of the state regulatory commissions' review and handling of related matters within their jurisdictions. Accordingly, we are not able to assess the total potential impact of the FCC orders and proposed rulemakings.

Broadband In June 2005, the Supreme Court of the United States (Supreme Court) ruled that it was reasonable for the FCC to find that internet access services provided by cable companies should be defined as "information services," rather than "telecommunications services." This decision preserves the FCC's deregulatory framework for cable internet access services because providers of information services do not have to comply with rules requiring providers of the services to lease lines to competitors or meet certain service standards and state public utility requirements. In September 2005, the FCC released its Broadband Order, which ruled that facilities-based wireline broadband internet access services offered by telephone companies are information services and should be regulated in a similar manner to broadband internet access services offered by cable companies. The order became effective on November 16, 2005.

The Broadband Order substantially deregulates our existing DSL services and prevents the imposition of regulation on broadband internet access services to be offered over Project Lightspeed. Under the Broadband Order we are no longer required to offer DSL transport service to unaffiliated Internet Service Providers (ISPs). However, we are required to make wholesale broadband transmission service available to existing customers for a 12-month transition period. The FCC also said it expects that after the transition period, telephone companies will make wholesale broadband transmission service available to ISPs on a commercial basis. We are also required to continue contributing to existing universal service support mechanisms for the transmission component of broadband internet access for 270 days after the effective date of the order (and thus until mid-August 2006), unless the FCC orders otherwise in the interim.

Video Service In November 2005, the FCC adopted two Notices of Proposed Rule Making (NPRM) that are of interest to us in connection with our provision of video service. First, the FCC adopted an NPRM to consider the adoption of rules that would ensure reasonable franchising requirements and processes for new video market entrants. The FCC's action is generally based on section 621 of Title VI, which prohibits local franchising authorities from unreasonably refusing to award competitive franchises. Second, the FCC adopted an NPRM to consider changing its Emergency Alert System (EAS) rules to take advantage of next-generation digital systems. One of the specific questions the FCC will consider is whether traditional telephone companies that plan to provide high-definition digital content to customers' homes through fiber-optic connections should have public alert and warning responsibilities.

Voice over Internet Protocol The term VoIP is generally used to describe the transmission of voice using internet-based technology. A company using this technology often can provide voice services at a lower cost because this technology uses bandwidth more efficiently than a traditional network and because this technology has not been subject to traditional telephone industry regulation. But, depending on the bandwidth allocated, VoIP services are not necessarily of the same quality as a traditional telephone service. While the deployment of VoIP will result in increased competition for our wireline voice services, it also presents growth opportunities for us to develop new products for our customers.

The FCC has issued a variety of decisions regarding VoIP services. For example, during 2004, the FCC declared that services that do not use the public switched telephone network (a traditional telephone network) to provide "peer-to-peer" service (i.e., a service through which subscribers communicate with each other solely over Internet Protocol networks) are unregulated.

- **IP-Enabled Services** In March 2004, the FCC opened a proceeding to establish the regulatory framework for IP-enabled services, including VoIP and other IP services, that involve use of a public switched telephone network (PSTN). In this proceeding, the FCC will address various regulatory issues, including universal service, intercarrier compensation, numbering, disability access and consumer protection. Notwithstanding the unresolved regulatory questions before the FCC and various state utility commissions, numerous communications providers, including AT&T, began providing various forms of VoIP in recent years or announced their intentions to do so in the near future. These providers include both established companies as well as new entrants.
- **VoIP E911 Order** In May 2005, the FCC required certain VoIP providers to include E911 capability in their VoIP services. E911 capability enables a subscriber to call public safety authorities (police, fire department, etc.) and have the subscriber's telephone number and location automatically transmitted to those authorities. The FCC's requirement applies to VoIP services that allow a user to send calls to a PSTN, including our wireline subsidiaries' traditional networks, and receive calls from the PSTN. In November 2005, we filed reports with the FCC detailing our compliance with the VoIP 911 rules for our HIPCS and AT&T CallVantage® VoIP services. A group of VoIP providers appealed the FCC's May 2005 order and the appeal is currently pending before the D.C. Circuit.
- **Vonage Decision** In November 2004, the FCC issued an order preempting the Minnesota Public Utilities Commission (MPUC) from applying its traditional telephone company regulations to Vonage Holding Corp.'s (Vonage) DigitalVoice service (which includes VoIP and other communications capabilities). The FCC concluded that DigitalVoice could not be separated into interstate and intrastate communications for regulatory purposes without thwarting federal laws and policies that mandate a minimalistic regulatory environment for these types of services. The FCC did not express its opinion on the applicability of Minnesota's general business laws concerning taxation, fraud, general commercial dealings, marketing and advertising. The FCC also left undecided broader questions regarding the regulatory obligations of IP-enabled services, which are being addressed in the FCC's proceeding on IP-enabled services. Finally, the FCC stated that it would preempt state regulation of other types of IP-enabled services having basic characteristics similar to DigitalVoice. These characteristics include: a requirement for a broadband connection from the user's location; a need for IP-compatible customer premises equipment; and a service offering that provides integrated capabilities and features that allow customers to manage personal communications, including receiving voice communications and accessing other features and capabilities, even video. Various parties, including state public utilities commissions, have filed appeals of the FCC order which are pending before the United States Court of Appeals for the Eighth Circuit.

Intercarrier Compensation Reform In October 2004, the Intercarrier Compensation Forum, a diverse group of telecommunications industry participants representing ILECs (including our wireline subsidiaries), CLECs, long-distance companies (including ATTC), rural telephone companies and wireless providers, submitted to the FCC a plan for reforming the current system of rates that telecommunications companies charge each other for network access and fees to ensure universal telephone service in the U.S. In February 2005, the FCC initiated a rulemaking proceeding to consider the plan and other proposals for intercarrier compensation reform. At this time, we are not able to predict when final rules will be issued or what those rules will require.

Reciprocal Compensation In 2001, the FCC ruled that telephone calls placed to ISPs are not subject to the reciprocal compensation requirements of the Telecom Act, which require the carrier that originates and transports a call on its network that terminates on another carrier's network in the same local calling area pay a fee to the terminating carrier. The FCC concluded that requiring reciprocal compensation for ISP-bound traffic caused market distortions because CLECs offering ISP services could recover a disproportionate share of their costs from other carriers, rather than from their ISP customers, since calls rarely originate from the ISP. The FCC then concluded that a system of bill-and-keep (under which carriers look to their own customers to recover their costs) would eliminate CLEC incentives to engage in such arbitrage. The FCC adopted an interim compensation plan for ISP-bound traffic while it considered broader intercarrier compensation reform. The interim plan, among other things, capped the rate paid for ISP-bound traffic (the "rate" cap), the total number of minutes that could be compensated (the "growth" cap) and limited compensation for traffic not previously exchanged between carriers prior to the order (the "new markets" rule). In October 2004, the FCC lifted the growth cap and new markets rule, but declined to modify the other restrictions in its 2001 order, including the rate cap. As a result of this 2004 ruling, we have been required to pay reciprocal compensation on additional ISP-bound traffic, which previously was not compensable because of the caps. However, due to our ability to renegotiate contracts with carriers these additional payments have not had a material effect on our financial statements.

Special Access Pricing Flexibility In October 2002, ATTC requested the FCC to revoke current pricing rules for special access services, a component of our wireline revenues and our AT&T Corp. segment expenses. ATTC subsequently filed a petition in the D.C. Circuit asking the court to require the FCC to act on ATTC's petition. In January 2004, the FCC filed its opposition to ATTC's petition, which was denied by the D.C. Circuit in January 2005. Also in January 2005, the FCC initiated a rulemaking proceeding to consider whether it should modify its pricing flexibility rules, and, if so, how. However, due to the magnitude of the issue and the current transitions at the FCC and within the telecommunications industry, an order is not expected before late 2006.

Number Portability For several years, customers have been able to retain their numbers when switching their local service between wireline companies (generally referred to as "local number portability"), and the FCC allowed ILECs to recover, through customer rate charges, their carrier-specific costs of implementing local number portability (LNP). We were allowed to recover our costs over a five-year term by charging on a per-line basis. However, the per-line rate charges were determined based on a projected number of access lines. Since the actual number of access lines has now turned out to be lower than estimated, in February 2005 we requested the FCC to grant an exception to the five-year limit on charges to recover LNP implementation costs to allow us to recover our costs over a longer period of time. If our request is granted, we would recover previously authorized costs of approximately $210. An order is expected by May 2006.

Settlement with AT&T Corp. In March 2005, we reached agreement to settle outstanding claims between the pre-merger companies SBC and ATTC. The largest portion of the payment related to ATTC agreeing to reimburse us for the adjustment of the UNE-P rates in California, Michigan, Ohio and Wisconsin. The agreement also settled claims relating to, among other items, traffic compensation, cellular roaming access, collocation (ATTC equipment located on our premises), long-distance presubscription and other transport issues. As part of the agreement, we also settled our pending lawsuit against ATTC for unpaid access charges due on terminating interexchange traffic transported partially over the Internet, with no effect on our financial statements. As a result of the settlement, in the first quarter of 2005 we recorded an increase in operating revenue of approximately $32 and a decrease in operating expense of approximately $29.

Proceeding on Other Postretirement Benefit Costs In March 2003, the FCC reinstated a proceeding which it claimed to have incorrectly terminated in 2002 relating to the costs of providing postretirement employee benefits other than pensions. The FCC asked local exchange companies, including our wireline subsidiaries, to provide additional information concerning the treatment of these postretirement costs in their 1996 access tariff filings and any other related matters. On March 30, 2005, the FCC issued an order terminating its investigation without requiring any adjustments to our 1996 tariff filings.

State Regulation A summary of significant 2005 state regulatory developments follows.

Texas Telecom Reform and Video Legislation In September 2005, Texas passed a state telecommunications law that encourages new competitors to enter the video market and reforms existing state telecom laws. Video franchises will be granted by the Public Utilities Commission of Texas (PUCT), territories will be defined by the applicant and fees will be based upon a statewide definition of gross revenues. Franchise holders cannot fail to provide service in local areas based on the income of residents; however, holders will not be subject to mandatory build-out requirements. The PUCT approved our application to become a video service provider in November 2005. The Texas law also established a new regulatory framework for retail price regulation. For telephone exchanges in populations exceeding 100,000 residents, as of January 1, 2006, residential access lines are deregulated by the state and the cap on certain vertical services will be removed beginning July 1, 2006.

In September 2005, the Texas Cable & Telecommunications Association filed a lawsuit in United States District Court, Austin Division, seeking to declare this new law unconstitutional and inconsistent with the Federal Cable Act.

California Audit On February 26, 2004, the CPUC decided several major monetary issues in the 1997-1999 audit of our California wireline subsidiary. The CPUC determined that we were in compliance with regulatory accounting rules for pension and depreciation and that no refunds were owed by our subsidiary to customers. The CPUC determined that we should fund amounts for certain employee benefits into a Voluntary Employee Beneficiary Association (VEBA) trust, which resulted in our March 2004 contribution of approximately $232. In April 2004, other parties filed petitions for rehearing. In December 2005, the CPUC denied the applications for rehearing.

California Intrastate Access Charges In August 2003, the CPUC opened a rulemaking to determine whether certain elements of state access charges (charges that our local exchange carrier receives from long-distance carriers for use of the local exchange network) should be eliminated or reduced. The CPUC, in a December 2004 decision, first addressed the issue whether we should be authorized to increase revenues from other services to offset lost revenues from reduced access charges, and further concluded that if access charges were eliminated it should order offsetting rate increases for us. In a proposed decision issued in December 2005, a CPUC administrative law judge would eliminate certain access charges that we would receive from long-distance carriers (lost annual revenue of approximately $130), but would authorize offsetting rate increases for recovery of approximately 75% of that amount starting after December 2006. We believe that the proposed decision is unlawful and have filed comments opposing its adoption. The CPUC is expected to address the issue in the first quarter of 2006.

Market Deregulation In addition to other state activity to adopt legislation to deregulate retail rates, during 2005, the PUCT adopted our market test evidence in total, despite opposition of the CLEC trade association and the Office of Public Utility Counsel. As a result of this action, as of January 1, 2006, we have the option to raise residential basic local exchange service prices in 40 exchanges in Texas. This action results in pricing flexibility for approximately 66% of our residential local service lines, including all residential lines in major cities. Texas vertical service products have enjoyed pricing flexibility since 1999 and all business lines were afforded local service pricing flexibility earlier this year. Additionally, in November 2005, Michigan updated the Michigan Telecommunications Act, which price deregulated all basic exchange rates except a primary residential service, effectively eliminating price regulation on all business access lines and most residential access lines.

State UNE Pricing Proceedings As discussed above in "Triennial Review Remand Order," in March 2005, the FCC issued the TRRO which eliminated our obligation to provide unbundled local switching (and thus the UNE-P) for the mass-market on a prospective basis. The FCC also eliminated our obligation prospectively to provide high-capacity loops and dedicated transport in certain markets. Also as discussed above, the FCC established a transition plan for existing mass-market UNE-P customers and high-capacity loops and dedicated transport circuits that no longer will be subject to unbundling. As a consequence, state regulatory commissions should have a more limited role over the scope and terms of our network element offerings.

In September 2004, the CPUC voted to increase the UNE-P rates. The order became effective immediately, allowing us to retroactively charge the new rates back to May 2002, as contemplated in the May 2002 interim order. In January 2005, a decision from the United States Court of Appeals for the Ninth Circuit remanded to the CPUC an appeal challenging how the CPUC had priced one component of the UNE-P rates in a previous order. During 2005, the CPUC addressed the issue on remand resulting in a favorable outcome for us.

COMPETITION

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

Wireline

Our wireline subsidiaries expect continued competitive pressure in 2006 from multiple providers in various markets, including facilities-based local competitors, interexchange carriers and resellers. In some markets, we compete with large cable companies such as Comcast Corporation, Cox Communications, Inc. and Time Warner Inc. for local and high-speed internet services customers and other telecommunications companies such as Verizon (via recently acquired MCI) for both long-distance and local services customers. Substitution of wireless and internet-based services for traditional local service lines also continues to increase. At this time, we are unable to quantify the effect of competition on the industry as a whole, or financially on this segment, but we expect both losses of market share in local service and gains resulting from business initiatives especially in the area of bundling of products and services including wireless and video, large-business data services, broadband and long-distance service.

Our wireline subsidiaries remain subject to regulation by state regulatory commissions for intrastate services and by the FCC for interstate services. In contrast, our competitors are often subject to less or no regulation in providing comparable voice and data services. Under the Telecom Act, companies seeking to interconnect to our wireline subsidiaries' networks and exchange local calls enter into interconnection agreements with us. Any unresolved issues in negotiating those agreements are subject to arbitration before the appropriate state commission. These agreements (whether fully agreed-upon or arbitrated) are then subject to review and approval by the appropriate state commission. As noted in the "Triennial Review Remand Order" discussion above, in March 2005, the FCC revised its rules and provided significant relief from unbundling by eliminating our obligation to provide local switching, and hence the UNE-P, for mass-market customers, subject to a 12-month transition period. During the 12-month transition period (which ends in March 2006), we are experiencing decreases in the number of UNE-P lines as competitors move to alternate arrangements to serve their customers or their customers choose an alternative technology. We could experience increased pressure on our operating revenues should a customer that was receiving service from a UNE-P provider switch to an alternative technology or facilities-based competitor (a competitor with its own network).

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

We continue to lose access lines due to competitors (e.g., wireless, cable and VoIP providers) who can provide comparable services at lower prices because they are not subject to traditional telephone industry regulation and have lower cost structures.

In response to these competitive pressures, for several years we have utilized a bundling strategy that rewards customers who consolidate their services (e.g., local and long-distance telephone, DSL, wireless and video) with us. In 2005, we continued to focus on bundling wireline and wireless services, including combined packages of minutes and video service through an agreement with EchoStar. During 2006, we will continue to develop innovative products that capitalize on our expanding fiber network.

AT&T Corp.

Our AT&T Corp. segment subsidiaries expect continued competition in 2006. As competitive regulatory and technological changes occur, including those occasioned by the Telecom Act, we anticipate that new and different competitors will enter and expand their position in the communications service markets. Our principal competitors include Verizon (via recently acquired MCI) and Sprint, as well as prepaid card providers. In addition, we face a number of international competitors including Equant, British Telecom and SingTel as well as from a number of large systems integrators such as International Business Machines and Electronic Data Systems.

In response to the previously discussed changes in the federal regulatory environment and the deregulation of the long-distance market over recent years, in 2004 ATTC announced that it would no longer actively market to mass-market consumer customers, and therefore is not affected to the same degree by those regulations as our wireline segment.

ATTC provides local, domestic interstate and international wholesale networking capacity and switched services to other service providers, primarily large ISPs using the largest class of nationwide Internet networks (Internet backbone), wireless carriers, CLECs, regional phone ILECs, cable companies and systems integrators. These services are subject to additional competitive pressures from the development of new technologies and the increased availability of domestic and international transmission capacity. As our competitors develop and expand their existing networks, our networks experience excess capacity. The introduction of new products and service offerings and increasing satellite, wireless, fiber-optic and cable transmission capacity for services similar to those provided by us continues to provide competitive pressures.

Cingular

Cingular faces substantial and increasing competition in all aspects of the wireless communications industry. Under current FCC rules, six or more PCS licensees, two cellular licensees and one or more enhanced specialized mobile radio licensees may operate in each of Cingular's markets, which results in the presence of multiple competitors. Cingular's competitors are principally three national (Verizon Wireless, Sprint Nextel Corp. and T-Mobile) and a larger number of regional providers of cellular, PCS and other wireless communications services.

Cingular may experience significant competition from companies that provide similar services using other communications technologies and services. While some of these technologies and services are now operational, others are being developed or may be developed in the future. Cingular competes for customers based principally on price, service offerings, call quality, coverage area and customer service. See discussion of EDGE technology in "Wireless" under "Expected Growth Areas" above.

Directory

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

ACCOUNTING POLICIES AND STANDARDS

Significant Accounting Policies and Estimates Because of the size of the financial statement line items they relate to, some of our accounting policies and estimates have a more significant impact on our financial statements than others.

Traffic Compensation We use various estimates and assumptions to determine the amount of traffic compensation expenses recognized during any reporting period. Switched traffic compensation costs in our AT&T Corp. segment are accrued utilizing estimated rates by product, formulated from historical data and adjusted for known rate changes and volume levels, which are estimated for certain products and known for other products. Such estimates are adjusted monthly to reflect newly available information, such as rate changes and new contractual agreements. Bills reflecting actual incurred information are generally not received until three to nine months following the end of the reporting period, at which point a final adjustment is made to the accrued switched traffic compensation expense. Dedicated traffic compensation costs are estimated based on the number of circuits and the average projected circuit costs, based on historical data adjusted for rate changes. These costs are adjusted to reflect actual expenses over the three months following the end of the reporting period as bills are received. As of December 31, 2005, approximately $940 was accrued in our AT&T Corp. segment relating to our estimated traffic compensation costs.

Depreciation Our depreciation of assets, including use of composite group depreciation and estimates of useful lives, is described in Notes 1 and 5. We assign useful lives based on periodic studies of actual asset lives. Changes in those lives with significant impact on the financial statements must be disclosed, but no such changes have occurred in the three years ended December 31, 2005. However, if all other factors were to remain unchanged, we expect a one-year increase in the useful lives of the largest categories of our plant in service (which accounts for more than three-fourths of our total plant in service) would result in a decrease of between $615 and $800 in our 2006 depreciation expense and a one-year decrease would result in an increase of between $745 and $1,175 in our 2006 depreciation expense. Effective January 1, 2003, as required by FAS 143, we decreased our depreciation rates to exclude costs of removal in certain circumstances. This change is discussed in Note 1.

Allowance for Uncollectibles We maintain an allowance for doubtful accounts for estimated losses that result from the failure or inability of our customers to make required payments. When determining the allowance, we consider the probability of recoverability of accounts receivable based on past experience, taking into account current collection trends that are expected to continue, as well as general economic factors, including bankruptcy rates. Credit risks are assessed based on historical write-offs, net of recoveries, and future estimated net write-offs as well as an analysis of the aged accounts receivable balances with reserves generally increasing as the receivable ages. Accounts receivable may be fully reserved for when specific collection issues are known to exist, such as pending bankruptcy or catastrophes. The analysis of receivables is performed monthly and the bad debt allowances adjusted accordingly. A 10% change in the amounts estimated to be uncollectible would result in a change in uncollectible expense of between approximately $70 and $110.

Pension and Postretirement Benefits Our actuarial estimates of retiree benefit expense and the associated significant weighted-average assumptions are discussed in Note 10. One of the most significant of these assumptions is the return on assets assumption, which was 8.5% for the year ending December 31, 2005. This assumption will remain unchanged for 2006. If all other factors were to remain unchanged, we expect a 1% decrease in the expected long-term rate of return would cause 2006 combined pension and postretirement cost to increase approximately $579 over 2005 (analogous decrease in retiree benefit costs would result from a 1% increase). The 10-year returns on our pension plan were 9.3% through 2005 including returns in excess of our assumed rate of return for 2005. Under GAAP, the expected long-term rate of return is calculated on the market-related value of assets (MRVA). GAAP requires that actual gains and losses on pension and postretirement plan assets be recognized in the MRVA equally over a period of up to five years. We use a methodology, allowed under GAAP, under which we hold the MRVA to within 20% of the actual fair value of plan assets, which can have the effect of accelerating the recognition of excess actual gains and losses into the MRVA in less than five years. This methodology did not have a significant additional effect on our 2005 or 2004 combined net pension and postretirement expense. Due to investment losses on plan assets experienced through 2002, this methodology contributed approximately $605 to our combined net pension and postretirement cost in 2003, as compared with the methodology that recognizes gains and losses over a full five years. Note 10 also discusses the effects of certain changes in assumptions related to medical trend rates on retiree health care costs.

Income Taxes Our estimates of income taxes and the significant items giving rise to the deferred assets and liabilities are shown in Note 9 and reflect our assessment of actual future taxes to be paid on items reflected in the financial statements, giving consideration to both timing and probability of these estimates. Actual income taxes could vary from these estimates due to future changes in income tax law or results from the final review of our tax returns by the IRS or state tax authorities. We have considered these potential changes and have provided amounts within our deferred tax assets and liabilities that reflect our judgment of the probable outcome of tax contingencies. We continue to believe that our tax return positions are fully supportable. Unfavorable settlement of any particular issue could require use of our cash. Favorable resolution could be recognized as a reduction to our tax expense and cash refunds. We periodically review the amounts provided and adjust them in light of changes in facts and circumstances, such as the progress of a tax audit.

Asset Valuations and Impairments Under FAS 141, the assets and liabilities of ATTC were recorded at their respective preliminary fair values as of the November 18, 2005 acquisition date. We obtained preliminary third-party valuations of property, plant and equipment, intangible assets (including the AT&T trade name), debt and certain other assets and liabilities. Because of the proximity of this transaction to year end, the values of certain assets and liabilities are based on preliminary valuations and are subject to adjustment as additional information is obtained. Such additional information includes, but is not limited to: valuations and physical counts of property, plant and equipment, valuations of investments and the involuntary termination of employees. Changes to the valuation of property, plant and equipment may result in adjustments to the fair value of certain identifiable intangible assets acquired. When finalized, material adjustments to goodwill may result including the segment allocation of goodwill.

The fair values of intangible assets acquired in our acquisition of ATTC were based on the expected discounted cash flows of the identified customer relationships, patents and licenses and are discussed in Note 2. Customer relationships, which are finite-lived intangible assets are amortized using the "sum of the months digits" method of amortization over the expected period in which those relationships are expected to contribute to our future cash flows, including consideration for demand, competition and other economic factors based in such a way as to allocate it as equitably as possible to periods during which we expect to benefit from those relationships. We have established the useful lives of customer relationships with business customers from 1.5 to 9 years and those with consumer customers from 1.5 to 2.5 years. The sum of the months digits method is a process of allocation, not of valuation and reflects our belief that we expect greater revenue generation from these customer relationships during the earlier years of their lives. We recorded amortization expense of $184 in 2005 using this method. Alternatively, we could have chosen to amortize customer relationships using the "straight-line" method, which would allocate the cost equally over the amortization period, and would have resulted in amortization expense of approximately $96 in 2005. In 2006, expected amortization using the sum of the months digit method is approximately $899 and under the straight-line method it would be $579. Amortization of other intangibles, including patents, is determined using the straight-line method of amortization over the expected remaining useful lives of 2 to 18 years, was approximately $8 in 2005 and is expected to be approximately $50 in 2006. We do not amortize indefinite-lived intangibles, such as the trade name.

In accordance with Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," we review these types of assets for impairment either annually or whenever events or circumstances indicate that the carrying amount may not be recoverable over the remaining life of the asset or asset group. In order to determine that the asset is recoverable, we verify that the expected future cash flows directly related to that asset exceed its fair value, which is based on the discounted cash flows. The discounted cash flow calculation uses various assumptions and estimates regarding future revenue, expense and cash flows projections over the estimated remaining useful life of the asset.

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

New Accounting Standards

FSP FAS No. 143-1 In June 2005, the FASB issued FASB Staff Position FSP FAS No. 143-1, "Accounting for Electronic Equipment Waste Obligations," (FSP FAS 143-1) to address the accounting for obligations associated with the Directive on Waste Electrical and Electronic equipment (the Directive) issued by the European Union (EU). The Directive was enacted in February 2003, and directs EU-member countries to adopt legislation to regulate the collection, treatment, recovery and environmentally sound disposal of electrical and electronic waste equipment. The Directive concludes that commercial users are obligated to retire, in an environmentally sound manner, specific assets that qualify as historical waste. FSP FAS 143-1 is effective for reporting periods ending after June 8, 2005, or the date of adoption of the Directive by the applicable EU-member countries, if later. We have evaluated the impact to our operations in ATTC's EU countries that have adopted the legislation and have deemed the costs immaterial. We will continue to evaluate the effects as other EU-member countries enact legislation. However, if the remaining EU-member countries were to enact similar legislation, we do not expect this to have a material impact on our results of operations.

FAS 154 In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting for Changes and Error Corrections," (FAS 154) which is a replacement of Accounting Principles Board (APB) Opinion No. 20, "Accounting Changes" and Statement of Financial Accounting Standards No. 3 "Reporting Accounting Changes in Interim Financial Statements" and is effective for fiscal years beginning after December 15, 2005. FAS 154 applies to all voluntary changes in accounting principle and changes the accounting for the reporting of a change in accounting principle. FAS 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principle unless it is impracticable. FAS 154 also requires that a change in method of depreciation, amortization or depletion for long-lived nonfinancial assets be accounted for as a change in accounting estimate that is effected by a change in accounting principle.

FIN 47 In March 2005, the FASB issued FASB Interpretations 47, "Accounting for Conditional Asset Retirement Obligations," (FIN 47) an interpretation of FAS 143 and is effective for fiscal years ended after December 15, 2005. FIN 47 clarifies that the term "conditional asset retirement obligation," as used in FAS 143 refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement is conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. FIN 47 requires a company to recognize the liability for the fair value of the conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Any liability accrued would be offset by an increase in the value of the asset. Adoption of FIN 47 did not have a material impact on our financial statements.

FAS 123(R) In December 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (FAS 123(R)), which is a revision of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (FAS 123). FAS 123(R) supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees," and amends Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows."

We adopted FAS 123(R) in September 2005, using the "modified retrospective" method. The modified retrospective method requires that compensation cost be recognized beginning with the effective date (a) based on the requirements of FAS 123(R) for all share-based payments granted after the effective date and (b) based on the requirements of FAS 123 for all awards granted to employees prior to the effective date of FAS 123(R) that remain unvested on the effective date. The modified retrospective method also allowed companies to restate based on the amounts previously recognized under FAS 123 for purposes of pro forma disclosures for all prior years for which FAS 123 was effective. Accordingly, we have adjusted our December 31, 2004 Consolidated Balance Sheet to increase "Capital in excess of par value" and decrease "Retained earnings" by $546.

We had previously adopted the fair-value-based method of accounting for share-based payments allowed under FAS 123 effective January 1, 2002, using the retroactive restatement method of adoption described in Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure." This included restatement of results from January 1, 2000 forward, as those were the years for which audited income statements were included in the 2002 SBC Annual Report. Upon adoption of FAS 123(R), because we adopted using the modified retrospective method, we also restated results for 1995 through 1999 for the effects on our equity. We will continue to use the Black-Scholes option-pricing model to estimate the fair value of stock options granted to employees.

As of December 31, 2005, there was approximately $143 of total unrecognized compensation cost related to nonvested stock-based compensation arrangements granted. That cost is expected to be recognized over a weighted-average period of 1.6 years.

OTHER BUSINESS MATTERS

Acquisition of AT&T Corp. In November 2005, we acquired ATTC for approximately $15,517 including capitalized merger-transaction costs, using shares of common stock. The transaction was approved by the Board of Directors of each company and shareholders of ATTC. The DOJ reviewed the merger's potential impact on relevant product and geographic markets. The DOJ required divestiture (through 10-year indefeasible rights of use) of ATTC's interest in fiber serving certain specified commercial buildings where both companies were the only facilities-based providers. The FCC and numerous state and international regulatory bodies also approved the acquisition. The FCC's order released on November 17, 2005, imposes conditions on us that relate, among other things, to: Unbundled Network Elements (UNE), DS1 and DS3 (high-capacity transport services) and special access pricing; how to account for ATTC collocation arrangements; special access performance reporting; Internet backbone peering arrangements; and annual certifications. As a condition of approval, the CPUC required that we make certain financial commitments, including philanthropic donations, with a present value of $124 and that we provide our DSL services on a stand-alone basis. These commitments were included as an additional acquisition cost. We do not expect the above-mentioned conditions will have a material impact on our financial statements.

2Wire In January 2006, AT&T, Alcatel and Telmex entered into an agreement and jointly acquired 51% of 2Wire, Inc. (2Wire). The total sum paid by the three companies was approximately $243. We purchased a 7.52% ownership interest for approximately $36, Alcatel purchased a 25.0% ownership interest for $119 and Telmex purchased an 18.5% ownership interest for $88. Additionally, we executed a prepaid call option (dependent on certain provisions) with Telmex for $26 to acquire enough shares to give us a total ownership percentage in 2Wire of 13%. We will account for 2Wire as a cost investment. 2Wire is a privately held company that provides services related to Project Lightspeed.

EchoStar Agreement In September 2005, we modified and extended our agreement with EchoStar to an agency agreement under which we will continue marketing the co-branded AT&T | DISH Network satellite television service. Under the new terms, we will now receive and record sales commissions as revenues and will no longer record retail revenue on new customers while continuing to serve previously existing customers on the prior terms. EchoStar will record the recurring service revenues and will pay installation and equipment costs for customers under the new agreement. The new agreement is a three-year agreement.

IRS Settlement In December 2005, we reached an agreement with the IRS to settle certain claims, principally related to the utilization of capital losses and tax credits for years 1997-1999. Included in the settlement was relief from previous assessments and agreement on multiple items challenged by the IRS in the course of routine audits. The settlement resulted in our recognition of approximately $902 of reduced income tax expense in 2005 and a corresponding increase in net income. Amounts due to us under the settlement were left on deposit with the IRS.

Antitrust Litigation In 2002, two consumer class-action antitrust cases were filed in the United States District Court for the Southern District of New York (District Court) against SBC, Verizon Communications Inc., BellSouth and Qwest Communications International Inc. alleging that they have violated federal and state antitrust laws by agreeing not to compete with one another and acting together to impede competition for local telephone services (Twombly v. Bell Atlantic Corp., et al.). In October 2003, the District Court granted the joint defendants' motion to dismiss and the plaintiffs appealed. In October 2005, the United States Court of Appeals for the Second Circuit Court (Second Circuit) reversed the District Court, thereby allowing the cases to proceed. The Second Circuit noted in its decision that its ruling was procedural in nature and did not address the merits of the cases. Motions for rehearing and rehearing en banc were denied on January 3, 2006, and the case has now been remanded to the District Court for further proceedings. We continue to believe that an adverse outcome having a material effect on our financial statements in these cases is unlikely but will continue to evaluate the potential impact of these suits on our financial results as they progress.

AT&T Wireless Litigation Several class-action lawsuits have been filed in the District Court against ATTC asserting claims under the federal securities laws in connection with the offering of AT&T Wireless tracking stock in April 2000 (In re AT&T Corp. Securities Litigation). The plaintiffs have demanded damages in excess of $2,100 related to the offering of AT&T Wireless tracking stock. A trial date has been set for April 2006. In connection with the split-off of AT&T Wireless, certain provisions of the separation agreement between AT&T Wireless and ATTC will result in Cingular, due to its acquisition of AT&T Wireless, being allocated as much as 70% of any liabilities arising out of these actions to the extent they relate to AT&T Wireless tracking stock, with the remaining liability being allocated equally between ATTC and Comcast Cable Communications, Inc. We believe that the possibility of an adverse outcome having a material effect on our financial statements in any of these lawsuits is unlikely. However, we will continue to evaluate the potential impact of these lawsuits on our financial results. During the third quarter, Cingular completed its assessment of the total amount of pre-acquisition liabilities related to pending legal proceedings, including these lawsuits, and increased the amount of the AT&T Wireless purchase price allocated to assumed liabilities by $172.

Retiree Phone Concession Litigation In May 2005, we were served with a purported class action in U.S. District Court, Western District of Texas (Stoffels v. SBC Communications Inc.), in which the plaintiffs, who are retirees of Pacific Bell Telephone Company, Southwestern Bell, and Ameritech, contend that the telephone concession provided by the company is, in essence, a "defined benefit plan" within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA). Plaintiffs seek to certify a class of persons that are either (1) retirees of the former subsidiaries of SBC or a predecessor thereof, who received the telephone concession benefit after they retired or (2) current or former employees of the former subsidiaries of SBC with more than 5 years of service during the time that they had a policy to provide employees with a telephone concession benefit upon retirement. Plaintiffs seek reformation of the out-of-region phone concession offered under the postemployment benefits plan (the Plan) and the documents governing it to comply with ERISA, an order requiring us to fund the Plan as reformed, the appointment of an independent fiduciary to administer the Plan, an order requiring the Plan to pay benefits to plaintiffs and other class members consistent with the terms of the plan and attorneys' fees and costs pursuant to ERISA. We filed a Motion to Dismiss for failure to state a claim, which was denied by the U.S. District Court, Western District of Texas on February 3, 2006. The case has been set for trial on May 29, 2006. We believe that an adverse outcome having a material effect on our financial statements in this case is unlikely but will continue to evaluate the potential impact of this suit on our financial results as it progresses.

Hepting Litigation Plaintiffs filed this purported class action in U.S. District Court in the Northern District of California on behalf of "all individuals in the United States that are current residential subscribers or customers of defendants' telephone services or internet services, or that were residential telephone or internet subscribers or customers at any time after September 2001," (Hepting, et al v. AT&T Corp., AT&T Inc. and Does 1-20). They allege that the defendants have provided and continue to provide the U.S. Government with direct access to databases containing its stored telephone and internet records, and have disclosed and are currently disclosing to the U.S. Government records concerning communications to which Plaintiffs and class members were a party. Plaintiffs seek damages, a declaratory judgment, and injunctive relief for violations of the First and Fourth Amendments to the United States Constitution, the Foreign Intelligence Surveillance Act, the Electronic Communications Privacy Act, and other federal and California statutes. The complaint has not been served on the Defendants.

LIQUIDITY AND CAPITAL RESOURCES

We had $1,224 in cash and cash equivalents available at December 31, 2005. Cash and cash equivalents included cash of approximately $709, money market funds of $257 and other cash equivalents of $258. The increase in cash and cash equivalents of $464 since December 31, 2004 was primarily provided by cash receipts from operations, cash received from Cingular and the net cash received upon our acquisition of ATTC. This was partially offset by cash used to meet the financing needs of the business including, but not limited to, payment of operating expenses, funding capital expenditures, dividends to stockholders, net repayment of debt, repurchase of treasury shares, increased tax payments and payment of liabilities (primarily taxes) associated with our discontinued operations. We discuss many of these factors in detail below.

Cash Provided by Operating Activities

During 2005, our primary source of funds was cash from operating activities of $12,974 compared to $10,950 in 2004. Operating cash flows increased in 2005 compared to 2004 primarily due to retirement benefit funding of $2,232 in 2004, partially offset by increased tax payments in 2005 of approximately $1,224. The 2005 increased tax payments were mainly related to prior year accrued liabilities. The timing of cash payments for income taxes, which is governed by the IRS and other taxing jurisdictions, will differ from the timing of recording tax expense and deferred income taxes, which are reported in accordance with GAAP. We also made advance tax payments, which we consider to be a refundable deposit, to a certain state jurisdiction. These payments were made in order to avoid potentially onerous interest and penalties. The issues involved are in dispute and we intend to pursue all procedural options available to us in order to obtain refunds of the amounts deposited.

We reached an agreement with the IRS to settle certain claims resulting in a reduction to income tax expense of $902. We left a net refund with the IRS as a deposit against federal tax payments.

Our 2004 cash flow from operations remained relatively stable compared to 2003, excluding the $2,232 contribution to our pension and postretirement benefit plans and a $2,800 decline in our deferred income tax expense. Our primary source of funds for 2004 and 2003 was cash generated from operating activities, as shown on the Consolidated Statements of Cash Flows.

Cash Used in and Provided by Investing Activities

During 2005, cash used for investing activities consisted of:

- $5,576 in construction and capital expenditures.
- $169 related to the acquisition of Yantra Corp., a provider of distributed order management and supply chain fulfillment solutions.

To provide high-quality communications services to our customers, we must make significant investments in property, plant and equipment. The amount of capital investment is influenced by demand for services and products, continued growth and regulatory considerations. Our capital expenditures totaled $5,576 for 2005, $5,099 for 2004 and $5,219 for 2003. Capital expenditures in the wireline segment, which represented substantially all of our total capital expenditures, increased by approximately 5.9% in 2005 and decreased by 2.8% in 2004. Substantially all of our capital expenditures made in 2005 were in the wireline segment and were used primarily for our wireline subsidiaries' networks, Project Lightspeed and support systems for our long-distance service.

Because of opportunities made available by the continued changing regulatory environment and our acquisition of ATTC, we expect that our capital expenditures in 2006, which includes Project Lightspeed and excludes Cingular, will increase to a target range of between $8,000 and $8,500. We expect to spend approximately $4,400 on our Project Lightspeed initiative for network related deployment costs and capital expenditures beginning in 2006 through 2008, as well as additional success-based customer activation capital expenditures. We expect that the business opportunities made available, specifically in the data/broadband area, will allow us to expand our products and services (see "Project Lightspeed" discussed in "Expected Growth Areas").

We expect to fund 2006 capital expenditures for our wireline and AT&T Corp. segments, which includes ATTC's international operations, using cash from operations and incremental borrowings, depending on interest rate levels and overall market conditions. Substantially all of our capital spending in 2006 will relate to our wireline and AT&T Corp. segments primarily for their subsidiaries' networks, Project Lightspeed and merger-integration projects. The international segment should be self-funding as it consists substantially of equity investments and not direct AT&T operations. We expect to fund any directory segment capital expenditures using cash from operations. We discuss our Cingular segment below.