Consolidated Communications Holdings, Inc.
Form 10-Q
November 06, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

þ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended September 30, 2009

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the Transition Period from ____ to____

Commission File Number 000-51446

CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**02-0636095**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

121 South 17th Street
Mattoon, Illinois 61938-3987
(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (217) 235-3311

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes o No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

The number of shares of the registrant s common stock, $.01 par value, outstanding as of November 3, 2009 was 29,642,228.

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PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

Consolidated Communications Holdings, Inc.
Condensed Consolidated Statements of Income
(Amounts in thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Revenues	$ 101,590	$ 103,824	$ 305,342	$ 315,682
Operating expenses:				
Cost of services and products (exclusive of depreciation and amortization shown separately below)	36,151	37,778	108,595	107,749
Selling, general and administrative expenses	25,600	26,162	79,327	81,217
Depreciation and amortization	21,341	22,841	63,999	68,062
Income from operations	18,498	17,043	53,421	58,654
Other income (expense):				
Interest income	10	41	47	329
Interest expense	(14,785)	(13,637)	(43,841)	(47,963)
Investment income	6,237	5,918	18,046	15,125
Loss on extinguishment of debt				(9,224)
Other, net	(183)	13	1,032	(101)
Income before income taxes	9,777	9,378	28,705	16,820
Income tax expense	2,494	4,262	10,066	7,410
Net income	7,283	5,116	18,639	9,410
Less: Net income attributable to noncontrolling interest	226	145	769	550
Net income attributable to Consolidated Communications Holdings, Inc.	$ 7,057	$ 4,971	$ 17,870	$ 8,860
Net income per share attributable to Consolidated Communications Holdings, Inc. common stockholders -				
Basic	$ 0.24	$ 0.17	$ 0.60	$ 0.30
Diluted	$ 0.24	$ 0.17	$ 0.60	$ 0.30
Cash dividends declared per common share	$ 0.39	$ 0.39	$ 1.16	$ 1.16

See accompanying notes

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Consolidated Communications Holdings, Inc.

Condensed Consolidated Balance Sheets
(Amounts in thousands, except share and per share amounts)

	September 30, 2009 (unaudited)	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 31,883	$ 15,471
Accounts receivable, net of allowance of $1,892 and $1,908, respectively	44,990	45,092
Inventories	7,118	7,482
Deferred income taxes	7,093	3,600
Prepaid expenses and other current assets	7,348	6,931
Total current assets	98,432	78,576
Property, plant and equipment, net	382,642	400,286
Intangibles and other assets:		
Investments	97,809	95,657
Goodwill	520,562	520,562
Customer lists, net	107,629	124,249
Tradenames	14,291	14,291
Deferred financing costs and other assets	6,926	8,005
Total assets	$ 1,228,291	$ 1,241,626
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of capital lease obligations	$ 581	$ 922
Current portion of pension and post retirement benefit obligations	2,960	2,960
Accounts payable	11,467	12,336
Advance billings and customer deposits	22,162	19,102
Dividends payable	11,484	11,388
Accrued expenses	22,435	24,584
Total current liabilities	71,089	71,292
Capital lease obligations less current portion		344
Long-term debt	880,000	880,000
Deferred income taxes	70,180	58,134
Pension and postretirement benefit obligations	100,577	107,741
Other liabilities	38,228	48,830
Total liabilities	1,160,074	1,166,341

Equity:		
Consolidated Communications Holdings, Inc. stockholders equity:		
Common stock, $0.01 par value, 100,000,000 shares, authorized, 29,642,228 and 29,488,408 issued and outstanding, respectively	296	295
Paid in capital	114,029	129,284
Retained earnings		
Accumulated other comprehensive loss	(52,062)	(59,479)
Total Consolidated Communications Holdings, Inc. stockholders equity	62,263	70,100
Noncontrolling interest	5,954	5,185
Total equity	68,217	75,285
Total liabilities and stockholders equity	$ 1,228,291	$ 1,241,626

See accompanying notes

Consolidated Communications Holdings, Inc.

Condensed Consolidated Statements of Cash Flows
(Amounts in thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2009	**2008**
OPERATING ACTIVITIES		
Net income	$ 18,639	$ 9,410
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	63,999	68,062
Loss on extinguishment of debt		9,224
Deferred income tax	8,553	(2,961)
Partnership income	(2,299)	(1,823)
Non-cash stock-based compensation	1,434	1,402
Amortization of deferred financing costs	978	1,119
Changes in operating assets and liabilities:		
Accounts receivable	102	(2,324)
Inventories	364	(730)
Other assets	651	(1,215)
Accounts payable	(869)	(6,665)
Accrued expenses and other liabilities	(9,342)	(6,853)
Net cash provided by operating activities	82,210	66,646
INVESTING ACTIVITIES		
Proceeds from sale of assets	300	
Capital expenditures	(30,952)	(37,131)
Net cash used in investing activities	(30,652)	(37,131)
FINANCING ACTIVITIES		
Proceeds from long-term obligations		120,000
Payments made on long-term obligations		(136,337)
Payment of deferred financing costs		(240)
Payment of capital lease obligation	(685)	(750)
Purchase and retirement of common stock	(9)	(8)
Dividends on common stock	(34,452)	(34,086)
Net cash used in financing activities	(35,146)	(51,421)
Net increase (decrease) in cash and cash equivalents	16,412	(21,906)
Cash and cash equivalents at beginning of period	15,471	34,341
Cash and cash equivalents at end of period	$ 31,883	$ 12,435

See accompanying notes

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Consolidated Communications Holdings, Inc.

Condensed Consolidated Statement of Changes in Stockholders Equity
Nine Months Ended September 30, 2009
(Amounts in thousands, except share amounts)
(Unaudited)

	Consolidated Communications Holdings, Inc. Stockholders Equity						
	Common Stock		Paid in	Retained	Accumulated Other Comprehensive	Noncontrolling	
	Shares	Amount	Capital	Earnings	Loss	Interest	Total
Balance, January 1, 2009	**29,488,408**	**$ 295**	**$ 129,284**	**$**	**$ (59,479)**	**$ 5,185**	**$ 75,285**
Net income				17,870		769	18,639
Dividends on common stock			(16,582)	(17,870)			(34,452)
Shares issued under employee plan, net of forfeitures	154,752	1	(1)				
Non-cash stock compensation			1,434				1,434
Purchase and retirement of common stock	(932)		(9)				(9)
Pension tax adjustment			(97)		97		
Change in prior service cost and net loss, net of $478 of tax					780		780
Change in fair value of cash flow hedges, net of $3,753 of tax					6,540		6,540
Balance, September 30, 2009	**29,642,228**	**$ 296**	**$ 114,029**	**$**	**$ (52,062)**	**$ 5,954**	**$ 68,217**

See accompanying notes

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CONSOLIDATED COMMUNICATIONS HOLDINGS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
Three and nine months ended September 30, 2009 and 2008

(1.) Description of Business

Consolidated Communications Holdings, Inc. and its wholly owned subsidiaries, which are collectively referred to as Consolidated , the Company , we , our or us unless the context otherwise requires, operates its businesses und name Consolidated Communications. The Company is an established rural local exchange company (RLEC) providing communications services to residential and business customers in Illinois, Texas and Pennsylvania. With 250,370 local access lines, an estimated 71,723 Competitive Local Exchange Carrier (CLEC) access line equivalents, 97,750 digital subscriber lines (DSL) and 21,518 Internet Protocol digital television (IPTV) subscribers at September 30, 2009, the Company offers a wide range of telecommunications services, including local and long distance service, digital telephone service (VOIP), custom calling features, private line services, dial-up and high-speed broadband internet access, IPTV, carrier access services, network capacity services over our regional fiber optic network, directory publishing and CLEC calling services. The Company also operates a number of complementary businesses, including telemarketing and order fulfillment; telephone services to county jails and state prisons; equipment sales; and operator services.

(2.) Presentation of Interim Financial Statements

These unaudited interim condensed consolidated financial statements include the accounts of Consolidated Communications Holdings, Inc. and its wholly owned subsidiaries and subsidiaries in which it has a controlling financial interest. All significant intercompany balances and transactions have been eliminated in consolidation.

We have prepared the unaudited interim condensed consolidated financial statements included herein pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in statements prepared in accordance with generally accepted accounting principles (GAAP) have been omitted pursuant to such rules and regulations, although we believe that the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2008.

The accompanying unaudited interim condensed consolidated financial statements presented herewith reflect all adjustments (consisting of only normal and recurring adjustments unless otherwise disclosed) which, in the opinion of management, are necessary for a fair presentation of the results of operations for the three and nine month periods ended September 30, 2009 and 2008. The results of operations for interim periods are not necessarily indicative of results to be expected for an entire year.

Certain prior year amounts have been reclassified to conform to the current year s presentation. These reclassifications had no effect on total assets, total stockholders equity, total revenue, income from operations or net income.

(3.) Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2009-01, *Generally Accepted Accounting Principles,* which establishes the FASB Accounting Standards Codification (the Codification) as the official single source of authoritative U.S. GAAP. All existing accounting standards are superseded. All other accounting guidance not included in the Codification will be considered non-authoritative. The Codification also includes all relevant SEC guidance organized using the same topical structure in separate sections within the Codification.

Following the Codification, the FASB will not issue new standards in the form of Statements, FASB Staff Positions or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates (ASU) which will serve to update the Codification, provide background information about the guidance and provide the basis for conclusions on the changes to the Codification.

The Codification is not intended to change GAAP, but it will change the way GAAP is organized and presented. The Codification is effective for our third quarter 2009 financial statements and the principal impact on our financial statements is limited to disclosures, as all future references to authoritative accounting literature will be referenced in accordance with the Codification.

In December 2007, the FASB issued authoritative guidance on the presentation of noncontrolling interests in consolidated financial statements. This guidance clarifies that a noncontrolling interest in a consolidated subsidiary should be reported as equity in the consolidated financial statements. It also requires consolidated net income to include the amounts attributable to both the parent and the noncontrolling interest. We adopted this guidance effective January 1, 2009 on a retrospective basis. As of December 31, 2008, equity increased by approximately $5.2 million for the reclassification of noncontrolling interests.

In December 2007, the FASB revised the authoritative guidance for business combinations. This guidance establishes principles and requirements for how the acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. This guidance significantly changes the accounting for business combinations in a number of areas, including the treatment of contingent consideration, preacquisition contingencies, transaction costs and restructuring costs. In addition, under the new guidance, changes in an acquired entity s deferred tax assets and uncertain tax positions after the measurement period will impact income tax expense. This guidance was effective for fiscal years beginning on or after December 15, 2008 and requires the immediate expensing of acquisition related costs associated with acquisitions completed after December 31, 2008. Adoption of this guidance on January 1, 2009 had no impact on the Company s results of operations and financial position. However, we expect this guidance will affect acquisitions made thereafter, though the impact will depend upon the size and nature of the acquisition.

In March 2008, the FASB issued authoritative guidance on disclosures about derivative instruments and hedging activities. This guidance addresses enhanced disclosures concerning (a) the manner in which an entity uses derivatives (and the reasons it uses them), (b) the manner in which derivatives and related hedged items are accounted for and (c) the effects that derivatives and related hedged items have on an entity s financial position, financial performance, and cash flows. This guidance was effective for financial statements issued for fiscal years and interim periods beginning on or after November 15, 2008. Adoption of this guidance on January 1, 2009 did not have a material impact on our financial position or results of operations (see Note 7).

In June 2008, the FASB issued authoritative guidance on the treatment of participating securities in the calculation of earnings per share (EPS). This guidance addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing EPS under the two-class method. This guidance was effective for fiscal years beginning on or after December 15, 2008. Adoption of this guidance on January 1, 2009 did not have a material impact on our results of operations and financial position, or on basic or diluted earnings per share.

In December 2008, the FASB issued guidance on an employers disclosures about postretirement benefit plan assets. This guidance requires additional disclosures about assets held in an employer s defined benefit pension or other postretirement plan, primarily related to categories and fair value measurements of plan assets. This guidance is effective for us as of December 31, 2009. Because this guidance applies only to financial statement disclosures, the adoption is not expected to have a material effect on our consolidated financial statements.

In April 2009, the FASB issued authoritative guidance on interim disclosures about fair value of financial instruments. This guidance requires disclosures about fair value of financial instruments for interim reporting periods as well as in annual financial statements for interim reporting periods ending after June 15, 2009. Adoption of this guidance had no effect on our results of operations or financial condition (see Note 8).

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In May 2009, the FASB issued authoritative guidance on subsequent events. This guidance establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. This guidance is effective for interim or annual financial periods ending after June 15, 2009. Adoption of this guidance did not have an impact on our consolidated results of operations or financial position (see Note 16).

In August 2009, the FASB updated its authoritative guidance on fair value measurements and disclosures. This update provides amendments to reduce potential ambiguity in financial reporting when measuring the fair value of liabilities. Among other provisions, this update provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the valuation techniques described in ASC Update 2009-05. ASC Update 2009-05 will become effective for our annual financial statements for the year ended December 31, 2009. We have not yet determined the impact that this update may have on our financial statements.

(4.) Goodwill and Customer Lists

The following table summarizes the carrying value of goodwill by segment:

(In thousands)	**September 30, 2009**	**December 31, 2008**
Telephone Operations	$ 519,428	$ 519,428
Other Operations	1,134	1,134
	$ 520,562	$ 520,562

The Company s customer lists consist of an established core base of customers that subscribe to its services. The carrying amount of customer lists is as follows:

(In thousands)	**September 30, 2009**	**December 31, 2008**
Gross carrying amount	$ 205,648	$ 205,648
Less: accumulated amortization	(98,019)	(81,399)
Net carrying amount	$ 107,629	$ 124,249

The aggregate amortization expense associated with customer lists was approximately $5.5 million for each of the three month periods ended September 30, 2009 and 2008, and approximately $16.6 million for each of the nine month periods ended September 30, 2009 and 2008. The net carrying value at September 30, 2009 is being amortized using a weighted average life of approximately 5.8 years.

(5.) Retirement and Other Postretirement Benefit Plans

We have 401(k) plans covering substantially all of our employees. We recorded expense with respect to these plans for the three month periods ended September 30, 2009 and 2008 of $0.6 million and $0.7 million, respectively, and expense of $2.0 million for the nine month periods ended September 30, 2009 and 2008. Contributions made under our defined contribution plans include a match, at the Company s discretion, based on employee salaries contributed to the plans.

We sponsor several defined benefit pension plans covering substantially all of our hourly employees. Certain salaried employees are also covered by these defined benefit plans, although the benefits of most salaried employees have been frozen. The pension plans, which generally are noncontributory, provide

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retirement benefits based on years of service and earnings. The Company contributes amounts sufficient to meet the minimum funding requirements as set forth in employee benefit and tax laws.

We have a qualified supplemental pension plan (the Restoration Plan) covering certain former North Pittsburgh employees. The Restoration Plan restores benefits that are precluded under the pension plan by Internal Revenue Service limits on compensation and benefits applicable to qualified pension plans, and by the exclusion of bonus compensation from the pension plan s definition of earnings. The cost associated with the Restoration Plan is included in the Pension Benefits columns in the table that follows.

We also currently provide other postretirement benefits (shown as Other Benefits in the table that follows) consisting of health care and life insurance for certain groups of retired employees. Retirees share in the cost of health care benefits, making contributions that are adjusted periodically either based upon collective bargaining agreements or because total costs of the program have changed. We generally pay covered expenses for retiree health benefits as they are incurred. Postretirement life insurance benefits are fully insured.

The following tables present the components of net periodic benefit cost:

	Pension Benefits		**Other Benefits**	
(In thousands)	**2009**	**2008**	**2009**	**2008**
Three months ended September 30,				
Service cost	$ 527	$ 498	$ 177	$ 170
Interest cost	2,789	2,837	450	552
Expected return on plan assets	(2,355)	(3,008)		
Amortization prior service cost	(10)	(4)	(240)	(158)
Amortization net (gain) loss	676	8	(5)	(26)
Net periodic benefit cost	$ 1,627	$ 331	$ 382	$ 538
Nine months ended September 30,				
Service cost	$ 1,582	$ 1,590	$ 610	$ 675
Interest cost	8,367	8,449	1,609	1,815
Expected return on plan assets	(7,066)	(9,518)		
Amortization prior service cost	(32)	(10)	(722)	(478)
Amortization net (gain) loss	2,029	24	(16)	
Net periodic benefit cost	$ 4,880	$ 535	$ 1,481	$ 2,012

The Company made cash contributions to its tax-qualified plans approximately $0.7 million and $0.1 million for the three months ended September 30, 2009 and 2008, respectively, and approximately $9.8 million and $0.2 million for the nine months ended September 30, 2009 and 2008, respectively. The increase in contributions to its pension funds for the three and nine month periods ended September 30, 2009 is primarily the result of the decline in the value of plan investments that occurred in 2008. Contributions of approximately $0.7 million are expected to be paid during the remaining three months for 2009.

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(6). Long-Term Debt

Long-term debt consists of the following:

(In thousands)	September 30, 2009	December 31, 2008
Senior Secured Credit Facility		
Revolving loan	$	$
Term loan	880,000	880,000
Obligations under capital lease	581	1,266
	880,581	881,266
Less: current portion	(581)	(922)
	$ 880,000	$ 880,344

In 2007, the Company, through certain of its wholly-owned subsidiaries, entered into a credit agreement with several financial institutions, which provides for borrowings of up to $950 million, consisting of a $760 million term loan facility, a $50 million revolving credit facility (including a $10 million sub-limit for letters of credit), and a $140 million delayed draw term loan facility (DDTL). The DDTL s sole purpose was for the funding of the redemption of our then outstanding senior notes plus any associated fees or redemption premium. As described more fully below, we borrowed $120 million under the DDTL on April 1, 2008, at which time the commitment for the remaining $20 million that was originally available under the DDTL expired. The other borrowings under the credit facility were used to retire a previously outstanding $464 million credit facility and to fund our acquisition of North Pittsburgh Systems, Inc. Borrowings under the credit facility are secured by substantially all of the assets of Consolidated with the exception of Illinois Consolidated Telephone Company. The term loan and DDTL require no principal reductions prior to maturity and thus mature in full on December 31, 2014. The revolving credit facility matures on December 31, 2013. There were no borrowings outstanding under the revolving credit facility as of September 30, 2009.

At our election, borrowings under the credit facilities bear interest at a rate equal to an applicable margin plus either a base rate or LIBOR. As of September 30, 2009, the applicable margin for interest rates was 2.50% per year for the LIBOR-based term loans and 1.50% for alternative base rate loans. The applicable margin for our $880 million term loan is fixed for the duration of the loan. The applicable margin for borrowings on the revolving credit facility is determined via a pricing grid. Based on our leverage ratio of 4.79:1 at September 30, 2009, borrowings under the revolving credit facility will be priced at a margin of 2.75% for LIBOR-based borrowings and 1.75% for alternative base rate borrowings for the three month period ending December 31, 2009. The applicable borrowing margin for the revolving credit facility is adjusted quarterly to reflect the leverage ratio from the prior quarter-end.

The weighted average interest rate incurred on our credit facilities during the three month periods ended September 30, 2009 and 2008, including the effect of interest rate swaps and the applicable margin, was 6.26% and 6.91% per annum, respectively.

The credit agreement contains various provisions and covenants, including, among other items, restrictions on the ability to pay dividends, incur additional indebtedness, issue capital stock, and commit to future capital expenditures. We have agreed to maintain certain financial ratios, including interest coverage, and total net leverage ratios, all as defined in the credit agreement. As of September 30, 2009, we were in compliance with the credit agreement covenants.

On April 1, 2008, we redeemed all $130 million of our then outstanding senior notes. The total amount of the redemption was approximately $136.3 million, including a call premium of $6.3 million. The senior note redemption and payment of accrued interest through the redemption date was funded using $120 million of borrowings on the DDTL together with cash on hand. We recognized a loss on extinguishment of debt of approximately $9.2 million

related to the redemption premium of $6.3 million and the write-off of unamortized deferred financing costs of $2.9 million.

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(7.) Derivatives

In order to manage the risk associated with changes in interest rates, we maintain interest rate swap agreements that effectively convert a portion of our floating-rate debt to a fixed-rate basis, thereby reducing the impact of interest rate changes on future cash interest payments. During the third quarter of 2009, the amount of our floating-rate term debt that was fixed as a result of the interest rate swap agreements totaled $740 million, or 84.1% of our outstanding debt. On September 30, 2009, the notional amount of outstanding floating to fixed interest rate swap agreements declined to $680 million. The swaps expire at various times from December 2009 through March 2013. The swaps are designated as cash flow hedges of our expected future interest payments. Under our interest rate swap agreements, we receive 3-month LIBOR based interest payments from the swap counterparties and pay a fixed rate.

In September 2008, due to the larger than normal spread between 1-month LIBOR and 3-month LIBOR, we added basis swaps, under which we make 3-month LIBOR-based payments less a fixed percentage to the basis swap counterparties, and receive 1-month LIBOR. At the same time, we began utilizing 1-month LIBOR resets on our credit facility. To further reduce potential future income statement impacts from hedge ineffectiveness, we de-designated the original interest rate swap contracts and re-designated them, in conjunction with the basis swaps, as of September 4, 2008 as a cash flow hedge designed to mitigate the changes in cash flows on our credit facility. The effect of the swap portfolio is to fix the cash interest payments on the floating portion of $680 million of debt at a weighted average LIBO rate of 4.43% exclusive of the applicable borrowing margin on the loans.

We report the gross fair market value of our derivatives in either Other Assets or Other Liabilities on the balance sheet and do not net swaps in an asset position against swaps in a liability position. The table below shows the balance sheet classification and fair value of our interest rate swaps designated as hedging instruments under the applicable accounting guidance:

(In thousands) September 30, 2009	Fair Value	December 31, 2008	Fair Value
Other Liabilities	$37,559	Other Liabilities	$47,908

In a cash flow hedge, the effective portion of the change in the fair value of the hedging derivative is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings during the same period in which the hedged item affects earnings. The change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings. The effect of the interest rate swaps on our financial performance for the periods presented was:

(In thousands)	For the three months ended September 30, 2009	September 30, 2008
Loss recognized in OCI on the effective portion of the derivatives, net of tax	$ (144)	$ (2,150)
Loss reclassified from Accumulated OCI into Interest Expense (Effective Portion)	(2,884)	
Gain (loss) recognized in Interest Expense on the ineffective portion of the derivatives	(7)	2,406

(In thousands)	For the nine months ended September 30, 2009	September 30, 2008
Gain (loss) recognized in OCI on the effective portion of the derivatives, net of tax	$ 6,540	$ (2,028)
Loss reclassified from Accumulated OCI into Interest Expense (Effective Portion)	(8,764)	
Gain recognized in Interest Expense on the ineffective portion of the derivatives	55	2,406

We expect to reclassify approximately $6.2 million from Accumulated Other Comprehensive Income to Interest Expense during the next twelve months.

In total, we have nineteen interest rate swaps. The counterparties to the various swaps are five major U.S. and European banks. None of the swap agreements provide for either Consolidated or the counterparties to post collateral nor do the agreements include any covenants related to the financial condition of Consolidated or the counterparties. The swaps of any counterparty that is a Lender as defined in our credit facility are secured along with the other creditors under the credit facility. Each of the swap agreements provides that in the event of a bankruptcy filing by either Consolidated or the counterparty, any amounts owed between the two parties would be offset in order to determine the net amount due between parties. This provision allows us to partially mitigate the risk of non-performance by a counterparty.

(8.) Fair Value Measurements

The Company s derivative instruments related to interest rate swap agreements are required to be measured at fair value on a recurring basis. The fair values of the interest rate swaps are determined using an internal valuation model which relies on the expected LIBOR based yield curve and estimates of counterparty and Consolidated s non-performance risk as the most significant inputs. Because each of these inputs are directly observable or can be corroborated by observable market data, we have categorized these interest rate swaps as Level 2 within the fair value hierarchy.

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The following table summarizes the valuation of our financial instruments which are carried at fair value as of September 30, 2009:

(In thousands)		Fair Value Measurements at Reporting Date Using		
Description	September 30, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest Rate Swaps	$ 37,559		$ 37,559	

The following table presents the Company s net liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) as defined by the applicable guidance at September 30, 2009:

(In thousands)	Measurements Using Significant Unobservable Inputs (Level 3) Interest Rate Swaps
Balance at December 31, 2008	$ 47,908
Settlements	(14,852)
Total gains or losses (realized/unrealized)	
Unrealized gain included in earnings	(62)
Unrealized gain included in other comprehensive income from basis swap	(1,361)
Unrealized loss included in other comprehensive income	5,693
Transfers out of level 3	(37,326)
Balance at September 30, 2009	$
The amount of total gain for the period included in earnings as a component of interest expense	$ 62

We have not elected the fair value option for any of our financial assets or liabilities. The carrying value of other financial instruments, including cash, accounts receivable, accounts payable and accrued liabilities approximate fair value due to their short maturities or variable-rate nature of the respective balances. The following table presents the other financial instruments that are not carried at fair value but which require fair value disclosure as of September 30, 2009 and December 31, 2008.

	As of September 30, 2009	As of December 31, 2008

(In thousands)	**Carrying Value**	**Fair Value**	**Carrying Value**	**Fair Value**
Investments, equity basis	$ 49,133	n/a	$ 46,817	n/a
Investments, at cost	$ 44,400	n/a	$ 44,400	n/a
Long-term debt	$880,000	$880,000	$880,000	$880,000

The Company s investments at September 30, 2009 and December 31, 2008 accounted for under both the equity and cost methods consist of minority positions in various cellular telephone limited partnerships. These investments are recorded using either the equity or cost methods, and it is not practical to estimate a fair value for these non-publicly traded entities.

Our long-term debt allows us to select a one month LIBOR re-pricing option, which we have elected. As such, the fair value of this debt approximates its carrying value.

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(9.) Stock-based Compensation

The following table summarizes restricted stock activity during the nine months ended September 30, 2009:

Non-vested restricted shares outstanding, December 31, 2008	105,528
Shares granted	157,991
Shares vested	(7,202)
Shares forfeited or retired	(3,239)
Non-vested restricted shares outstanding, September 30, 2009	253,078

We recognized non-cash stock-based compensation expense associated with our restricted share plan of approximately $0.5 million for each of the three month periods ended September 30, 2009 and 2008, and expense of approximately $1.4 million for each of the nine month periods ended September 30, 2009 and 2008. The shares granted during the nine months ended September 30, 2009 includes 96,447 restricted shares granted to certain key employees and directors as well as 61,544 performance based restricted shares. The performance based restricted shares were granted to key employees upon the Company achieving certain financial and operating targets for 2008 based on a sliding scale. In March 2009, a target of 97,487 performance based restricted shares were approved for issuance in the first quarter of 2010 based upon meeting certain operational and financial goals in 2009. The non-cash stock-based compensation expense is included in Selling, general and administrative expenses in the accompanying condensed consolidated statements of income.

(10.) Income Taxes

During the nine months ended September 30, 2009, we recorded no significant change to the balance of unrecognized tax benefits reported at December 31, 2008. At both September 30, 2009 and December 31, 2008, we had recorded unrecognized tax benefits totaling $5.7 million. All of our unrecognized tax benefits, if recognized in future periods, would impact our effective tax rate. We do not expect any changes in our unrecognized tax benefits during the remainder of 2009.

Our practice is to recognize interest and penalties related to income tax matters in interest expense and general and administrative expense, respectively. Upon adoption of the FASB authoritative guidance on accounting for uncertainty in income taxes, we had no recorded liability for interest and penalties on unrecognized tax benefits. We had $0.9 million of interest and penalties relating to unrecognized tax benefits recorded as of September 30, 2009, of which a net $0.3 million was recorded during the nine months ended September 30, 2009 and $0.2 million was recorded during the nine months ended September 30, 2008. The net increase of $0.3 million for 2009 relates principally to the continued accrual of interest and penalties on our remaining unrecognized tax benefits.

During the first quarter of 2009, we settled an IRS exam covering tax years 2005 through 2007 for the Consolidated Communications Holdings, Inc. consolidated filing group. As a result, we recorded additional income tax expense of $0.1 million. The only federal return periods subject to examination are the 2006 and 2007 consolidated returns for the acquired North Pittsburgh Systems, Inc. consolidated filing group, the 2006 through 2009 returns for East Texas Fiber Line, a non-consolidated subsidiary, and the 2008 consolidated return for the Consolidated Communications Holdings, Inc. consolidated filing group. The periods subject to examination for our state returns are for tax years 2005 through 2008. We are currently under examination by state tax authorities. We do not expect any settlement or payment that may result from the audits to have a material effect on our results of operations or cash flows. A decrease in unrecognized tax benefits of $5.4 million and $0.9 million of related accrued interest and penalties is expected in the next 12 months due to the settlement of audits and the expiration of federal and state statutes of limitations. There were no material changes to any of these amounts during the third quarter of 2009.

Our effective tax rate was 35.1% and 44.1%, for the nine months ended September 30, 2009 and 2008, and 25.5% and 45.4% for the three months ended September 30, 2009 and 2008, respectively. The effective rates in 2009 are lower than 2008 due to state tax planning and completion of an internal restructuring as of December 31, 2008. The effective tax rate differs from the federal and state statutory rates primarily due to non-deductible expenses.

We filed 2008 tax returns for the Consolidated Communications Holdings, Inc. consolidated filing group and East Texas Fiber Line during the third quarter of 2009. We filed 2007 tax returns for the Consolidated Communications Holding, Inc. consolidated filing group, East Texas Fiber Line and the North Pittsburgh Systems, Inc. consolidated filing group during the third quarter of 2008. We recognized approximately $0.9 million of tax benefit in the third quarter of 2009 to adjust our 2008 provision to match our 2008 returns, and $0.2 million of tax benefit in the third quarter of 2008 to adjust our 2007 provision to match our 2007 returns.

(11.) Net Income per Common Share

As discussed in Note 3, we adopted the FASB s authoritative guidance on the treatment of participating securities in the calculation of earnings per share on January 1, 2009 and began using the two-class method to compute basic and diluted earnings per share for all periods presented. The following illustrates the earnings allocation method utilized in the calculation of basic and diluted earnings per share.

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(In thousands, expect per share amounts)	Three Months Ended September 30, 2009	Three Months Ended September 30, 2008	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2008
Basic Earnings Per Share Using Two-class Method:				
Net income	$ 7,283	$ 5,116	$ 18,639	$ 9,410
Less: Net income attributable to noncontrolling interest	226	145	769	550
Net income attributable to common stockholders before allocation of earnings to participating securities	7,057	4,971	17,870	8,860
Less: Earnings allocated to participating securities	90		271	
Net income attributable to common stockholders	6,967	4,971	17,599	8,860
Weighted average number of common shares outstanding	29,389	29,315	29,388	29,315
Net income per common share attributable to common stockholders basic	$ 0.24	$ 0.17	0.60	$ 0.30
Diluted Earnings Per Share Using Two-class Method:				
Net income attributable to common stockholders before allocation of earnings to participating securities	$ 7,057	$ 4,971	$ 17,870	$ 8,860
Less: Earnings allocated to participating securities	90		271	
Net income attributable to common stockholders before the reallocation of earnings to participating securities	6,967	4,971	17,599	8,860
Reallocation of earnings of participating securities				
Net income attributable to common stockholders	6,967	4,971	17,599	8,860
Weighted average number of common shares outstanding basic	29,389	29,315	29,388	29,315
Dilutive impact of share-based compensation				
Weighted average number of common shares outstanding diluted	29,389	29,315	29,388	29,315
Net income per common share attributable to common stockholders diluted	$ 0.24	$ 0.17	$ 0.60	$ 0.30

We had 0.3 million and 0.2 million potentially dilutive securities outstanding representing unvested shares of restricted stock at September 30, 2009 and 2008, respectively, that were not included in the computation of potentially dilutive securities because they were anti-dilutive, and were therefore excluded from the calculation of diluted earnings per share in accordance with the FASB s guidance on earnings per share.

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(12.) Comprehensive Income

The following table presents the components of comprehensive income:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	**2009**	**2008**	**2009**	**2008**
Net income	$ 7,283	$ 5,116	$ 18,639	$ 9,410
Other comprehensive income (loss):				
Prior service cost and net loss, net of tax	259	(115)	780	(295)
Change in fair value of cash flow hedges, net of tax	(143)	(2,150)	6,540	(2,028)
Total other comprehensive income (loss), net of tax	116	(2,265)	7,320	(2,323)
Comprehensive income	7,399	2,851	25,959	7,087
Less: Comprehensive income attributable to noncontrolling interest	226	145	769	550
Comprehensive income attributable to Consolidated Communications Holdings, Inc.	$ 7,173	$ 2,706	$ 25,190	$ 6,537

(13.) Discontinuance of Accounting for the Effects of Certain Types of Regulation

Historically, our Illinois and Texas ILEC operations followed the FASB s authoritative guidance for regulated enterprises in accounting for the effects of certain types of regulation. This authoritative guidance required the recognition of the economic effects of rate regulation by recording costs and a return on investment as such amounts are recovered through rates authorized by regulatory authorities. Changes to our business, however, have impacted the dynamics of our operating environment. In the last half of 2008, we experienced a significant increase in competition in our Illinois and Texas markets primarily due to traditional cable competitors offering voice services. Also, effective July 1, 2008, we made an election to transition from rate of return to price cap regulation at the interstate level for our regulated Illinois and Texas operations. The conversion to price caps provides for greater pricing flexibility, especially in the increasingly competitive special access segment and in launching new products. Additionally, in response to customer demand, we launched our own digital telephone service product offering as an alternative to our traditional wireline services. While there have been no material changes in our bundling strategy or in our end-user pricing, the pricing structure is transitioning from being based on the recovery of costs to a pricing structure based on market conditions.

Based on these and other factors impacting our business, we determined in late 2008 that the applicability of the authoritative guidance for regulated enterprises was no longer appropriate in the reporting of our financial results. As a result, we began to apply the authoritative guidance required for the discontinuance of application of regulatory accounting. This authoritative guidance requires the elimination of the effects of any actions of regulators that had been previously been recognized in accordance with the authoritative guidance for regulated enterprises, but that would not have been recognized by nonregulated enterprises. Depreciation rates of certain assets established by regulatory authorities for our telephone operations subject to the authoritative guidance for regulated enterprises have historically included a systematic charge for removal costs in excess of the related estimated salvage value on those assets, resulting in a net over-depreciation of those assets over their useful lives. Costs of removal were then appropriately applied against this reserve. Upon discontinuance of the authoritative guidance for regulated enterprises, we reversed the impact of recognizing removal costs in excess of the related estimated salvage value, which resulted in recording a non-cash extraordinary gain of approximately $7.2 million, net of taxes of approximately $4.2 million in the three months ended December 31, 2008. Our Pennsylvania ILEC previously discontinued the application of the authoritative guidance for regulated enterprises prior to our acquisition of North Pittsburgh, and, as a result, was not affected by the change in 2008.

(14.) Business Segments

We view and manage our businesses as two separate, but highly integrated, reportable business segments, Telephone Operations and Other Operations . Telephone Operations consists of a wide range of telecommunications services, including local and long distance service, digital telephone service (VOIP),

custom calling features, private line services, dial-up and high speed broadband internet access, IPTV, carrier access services, network capacity services over a regional fiber optic network, and directory publishing. We also operate a number of complementary businesses that comprise Other Operations, including telemarketing and order fulfillment, telephone services to county jails and state prisons, equipment sales, and operator services. Management evaluates the performance of these business segments based upon revenue, gross margins, and net operating income.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	**2009**	**2008**	**2009**	**2008**
Operating revenues				
Telephone Operations	$ 91,279	$ 94,323	$ 274,117	$ 284,934
Other Operations	10,311	9,501	31,225	30,748
Total	$ 101,590	$ 103,824	$ 305,342	$ 315,682
Operating income				
Telephone Operations	$ 18,108	$ 17,204	$ 52,508	$ 58,804
Other Operations	390	(161)	913	(150)
Total	18,498	17,043	53,421	58,654
Interest income	10	41	47	329
Interest expense	(14,785)	(13,637)	(43,841)	(47,963)
Investment income	6,237	5,918	18,046	15,125
Loss on extinguishment of debt				(9,224)
Other, net	(183)	13	1,032	(101)
Income before income taxes	$ 9,777	$ 9,378	$ 28,705	$ 16,820

(15.) Litigation and Contingencies

On October 23, 2006, Verizon Pennsylvania, Inc. and several of its affiliates filed a formal complaint with the Pennsylvania Public Utility Commission (PAPUC) claiming that our Pennsylvania CLEC s intrastate switched access rates violated Pennsylvania law. The provision of Pennsylvania law that Verizon cited in its complaint requires CLEC intrastate switched access rates to be no higher than the corresponding incumbent rates unless the CLEC could demonstrate that the higher access rates were cost justified . Verizon s original claim requested a refund of approximately $0.5 million for access billings through August 2006. Verizon later amended its complaint to include amounts from certain affiliates that had not been included in the original calculation. Verizon s revised complaint sought approximately $1.3 million in refunds through December 2006.

We believe that our CLEC s switched access rates were permissible and valid under PAPUC rules. In an initial decision dated December 5, 2007, the presiding administrative law judge recommended that the PAPUC sustain Verizon s complaint. As relief, the judge directed our Pennsylvania CLEC to reduce its access rates down to those of the underlying incumbent exchange carrier and refund to Verizon an amount equal to the access charges collected in excess of the new rate since November 30, 2004. We filed exceptions to the full PAPUC, which requested that Verizon and Consolidated attempt to resolve the issue through mediation.

On July 10, 2009, we entered into a settlement agreement with Verizon Pennsylvania, Inc. resolving its complaint, recurring access rates and any liability issues. As a result, we reduced the previously recorded reserve we had established down to the settlement amount and recognized a gain of approximately $1.8 million during the second

quarter 2009.

On April 15, 2008, Salsgiver Inc., a Pennsylvania-based telecommunications company, and certain of its affiliates filed a lawsuit against us and our subsidiaries North Pittsburgh Telephone Company and North Pittsburgh Systems Inc. in the Court of Common Pleas of Allegheny County, Pennsylvania, alleging that we have prevented Salsgiver from connecting its fiber optic cables to North Pittsburgh s utility poles. Salsgiver

seeks compensatory and punitive damages as the result of alleged lost projected profits, damage to its business reputation, and other costs. It claims to have sustained losses of approximately $125 million, but does not request a specific dollar amount in damages. We believe that these claims are without merit and, regardless of the merit of the claims, the damages are completely unfounded. We intend to defend against these claims vigorously. In the third quarter of 2008, we filed preliminary objections and responses to Salsgiver s complaint; however, the court ruled against our preliminary objections. On November 3, 2008, we responded to Salsgiver s amended complaint and filed a counter claim for trespass due to attaching to our poles without an authorized agreement and in an unsafe manner. We do not believe that these claims will have a material adverse impact on our financial results.

We are from time to time involved in various legal proceedings and regulatory actions arising out of our operations. We are not involved in any legal or regulatory proceedings, individually or in the aggregate (other than those described herein), that we believe would have a material adverse effect upon our business, operating results or financial condition.

(16.) Subsequent Events

We have evaluated all subsequent events through November 6, 2009, which represents the filing date of this Form 10-Q with the SEC, to ensure that this Form 10-Q includes appropriate disclosure of events both recognized in the financial statements as of September 30, 2009, and events which occurred subsequent to September 30, 2009 but were not recognized in the financial statements. As of November 6, 2009, there were no subsequent events which required recognition or disclosure.

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

We present below Management s Discussion and Analysis of Financial Condition and Results of Operations of Consolidated Communications Holdings, Inc. and its subsidiaries on a consolidated basis. The following discussion should be read in conjunction with our historical financial statements and related notes contained elsewhere in this Report.

Consolidated Communications or the Company refers to Consolidated Communications Holdings, Inc. alone or with its wholly owned subsidiaries, as the context requires. When this report uses the words we, our, or us, they refer to the Company and its subsidiaries.

Forward-Looking Statements

Any statements contained in this Report that are not statements of historical fact, including statements about our beliefs and expectations, are forward-looking statements and should be evaluated as such. The words anticipates , believes , expects , intends , plans , estimates , targets , projects , should , may , will and similar words intended to identify forward-looking statements. These forward-looking statements are contained throughout this Report, including, but not limited to, statements found in this Part I Item 2 Management s Discussion and Analysis of Financial Condition and Results of Operations , Part I Item 3 Quantitative and Qualitative Disclosures about Market Risk and Part II Item 1 Legal Proceedings . Such forward-looking statements reflect, among other things, our current expectations, plans, strategies, and anticipated financial results and involve a number of known and unknown risks, uncertainties, and factors that may cause our actual results to differ materially from those expressed or implied by these forward-looking statements, including but not limited to:

- various risks to stockholders of not receiving dividends and risks to our ability to pursue growth opportunities if we continue to pay dividends according to our current dividend policy;
- the current volatility in economic conditions and the financial markets;
- adverse changes in the value of assets or obligations associated with our employee benefit plans;
- various risks to the price and volatility of our common stock;
- our substantial amount of debt and our ability to incur additional debt in the future;
- our need for a significant amount of cash to service and repay our debt and to pay dividends on our common stock;
- restrictions contained in our debt agreements that limit the discretion of our management in operating our business;
- the ability to refinance our existing debt as necessary;
- rapid development and introduction of new technologies and intense competition in the telecommunications industry;
- risks associated with our possible pursuit of future acquisitions;
- the length and severity of weakened economic conditions in our service areas in Illinois, Texas and Pennsylvania;
- system failures;
- loss of large customers or government contracts;
- risks associated with the rights-of-way for our network;
- disruptions in our relationship with third party vendors;
- loss of key management personnel and the inability to attract and retain highly qualified management and personnel in the future;

changes in the extensive governmental legislation and regulations governing telecommunications providers, the provision of telecommunications services and access charges and subsidies, which are a material part of our revenues;

telecommunications carriers disputing and/or avoiding their obligations to pay network access charges for use of our network;

high costs of regulatory compliance;

the competitive impact of legislation and regulatory changes in the telecommunications industry;

liability and compliance costs regarding environmental regulations; and

the additional risk factors outlined in Part I Item 1A Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2008, and the other documents that we file with the SEC from time to time that could cause our actual results to differ from our current expectations and from the forward-looking statements discussed in this Report.

Many of these risks are beyond our ability to control or predict. All forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the cautionary statements contained throughout this Report. Because of these risks, uncertainties, and assumptions, you should not place undue reliance on these forward-looking statements. Furthermore, forward-looking statements speak only as of the date they are made. Except as required under the federal securities laws or the rules and regulations of the SEC, we do not undertake any obligation to update or review any forward-looking information, whether as a result of new information, future events or otherwise.

Overview

We are an established rural local exchange company that provides communications services to residential and business customers in Illinois, Texas, and Pennsylvania. Our main sources of revenues are our local telephone businesses, which offer an array of services, including local dial tone; digital telephone service (VOIP); custom calling features; private line services; long distance; dial-up internet access; high-speed broadband internet access, which we refer to as Digital Subscriber Line or DSL; inside wiring service and maintenance; carrier access; billing and collection services; telephone directory publishing; wholesale transport services on a fiber optic network in Texas; and Internet Protocol digital video service, which we refer to as IPTV. We also operate a number of complementary businesses that offer telephone services to county jails and state prisons, operator services, equipment sales, telemarketing, and order fulfillment services.

Acquisition of North Pittsburgh and new credit facility

On December 31, 2007, we completed our acquisition of North Pittsburgh Systems, Inc (North Pittsburgh). At the effective time of the merger, 80% of the shares of North Pittsburgh common stock converted into the right to receive $25.00 in cash, without interest, per share, for an approximate total of $300.1 million. Each of the remaining shares of North Pittsburgh common stock converted into the right to receive 1.1061947 shares of our common stock, or an approximate total of 3.32 million shares. The total purchase price, including fees, was $347.0 million, net of cash acquired.

In connection with the acquisition, we, through certain of our wholly-owned subsidiaries, entered into a credit agreement with various financial institutions. The credit agreement provided for aggregate borrowings of $950 million, consisting of a $760 million term loan facility, a $50 million revolving credit facility (which remains fully available as of September 30, 2009 and includes a $10 million sub-limit for letters of credit), and a $140 million delayed draw term loan facility. We borrowed $120 million under the delayed draw term loan facility on April 1, 2008, to redeem our then outstanding senior notes. The commitment for the remaining $20 million under the delayed draw facility expired. Borrowings under the credit facility were also used to retire our previous $464 million credit facility and to fund the acquisition of North Pittsburgh.

Redemption of senior notes

On April 1, 2008, we redeemed all of our then outstanding 9.75% senior notes using $120 million borrowed under the delayed draw term loan and cash on hand. The total amount of the redemption was approximately $136.3 million, including a redemption premium of 4.875%, or $6.3 million. We recognized a $9.2 million loss on the redemption of the notes. As a result of the transaction, we expect to realize a $4.0 million reduction in annualized cash interest expense.

Discontinuance of Accounting for the Effects of Certain Types of Regulation

Historically, our Illinois and Texas ILEC operations followed the FASB s authoritative guidance for regulated enterprises in accounting for the effects of certain types of regulation. This authoritative guidance required the recognition of the economic effects of rate regulation by recording costs and a return on investment as such amounts are recovered through rates authorized by regulatory authorities. Changes to our business, however, have impacted the dynamics of our operating environment. In the last half of 2008, we experienced a significant increase in competition in our Illinois and Texas markets primarily due to traditional cable competitors offering voice services. Also, effective July 1, 2008, we made an election to transition from rate of return to price cap regulation at the interstate level for our regulated Illinois and Texas operations. The conversion to price caps provides for greater pricing flexibility, especially in the increasingly competitive special access segment and in launching new products. Additionally, in response to customer demand, we launched our own digital telephone service product offering as an alternative to our traditional wireline services. While there have been no material changes in our bundling strategy or in our end-user pricing, the pricing structure is transitioning from being based on the recovery of costs to a pricing structure based on market conditions.

Based on these and other factors impacting our business, we determined in late 2008 that the applicability of the authoritative guidance for regulated enterprises was no longer appropriate in the reporting of our financial results. As a result, we began to apply the authoritative guidance required for the discontinuance of application of regulatory accounting. This authoritative guidance requires the elimination of the effects of any actions of regulators that had been previously been recognized in accordance with the authoritative guidance for regulated enterprises, but that would not have been recognized by nonregulated enterprises. Depreciation rates of certain assets established by regulatory authorities for our telephone operations subject to the authoritative guidance for regulated enterprises have historically included a systematic charge for removal costs in excess of the related estimated salvage value on those assets, resulting in a net over-depreciation of those assets over their useful lives. Costs of removal were then appropriately applied against this reserve. Upon discontinuance of the authoritative guidance for regulated enterprises, we reversed the impact of recognizing removal costs in excess of the related estimated salvage value, which resulted in recording a non-cash extraordinary gain of approximately $7.2 million, net of taxes of approximately $4.2 million in the three months ended December 31, 2008. Our Pennsylvania ILEC previously discontinued the application of the authoritative guidance for regulated enterprises prior to our acquisition of North Pittsburgh, and, as a result, was not affected by the change in 2008.

Factors affecting results of operations

Revenues

Telephone Operations and Other Operations. Our revenues are derived primarily from the sale of voice and data communication services to residential and business customers in our rural telephone companies service areas. Because we operate primarily in rural service areas, we do not anticipate significant growth in revenues in our Telephone Operations segment, except through acquisitions such as that of North Pittsburgh. However, we do expect relatively consistent cash flow from year to year because of stable customer demand, and a generally supportive regulatory environment.

Local access lines and bundled services. An access line is the telephone line connecting a home or business to the public switched telephone network. The number of local access lines in service directly affects the monthly recurring revenue we generate from end users, the amount of traffic on our network, the access

charges we receive from other carriers, the federal and state subsidies we receive, and most other revenue streams. We had 250,370 and 264,323 local access lines in service as of September 30, 2009 and December 31, 2008, and 270,352 at September 30, 2008.

Most wireline telephone companies have experienced a loss of local access lines due to challenging economic conditions and increased competition from wireless providers, competitive local exchange carriers and, in some cases, cable television operators. We have not been immune to these conditions. In 2008, both Suddenlink and Comcast, cable competitors in Texas, as well as NewWave Communications in Illinois, launched a competing voice product, which contributed to a spike in our line loss. We estimate that cable companies are now offering voice service to all of their addressable customers, covering 85% of our entire service territory.

We have been able in some instances to offset the decline in local access lines with increased average revenue per access line by:

- aggressively promoting DSL service, including selling DSL as a stand-alone offering;
- value bundling services, such as DSL or IPTV, with a combination of local service and custom calling features;
- maintaining excellent customer service standards; and
- keeping a strong local presence in the communities we serve.

We have implemented a number of initiatives to gain new local access lines and retain existing lines by making bundled service packages more attractive (for example, by adding unlimited long distance) and by announcing special promotions, like discounted second lines. We also market a triple play bundle, which includes local telephone service, DSL, and IPTV. As of September 30, 2009, IPTV was available to over 169,800 homes in our markets. Our IPTV subscriber base has grown from 15,454 as of September 30, 2008, to 21,518 as of September 30, 2009. We also continue to experience substantial growth in the number of DSL subscribers we serve. We had 97,750, 91,817 and 89,129 DSL lines in service as of September 30, 2009, December 31, 2008 and September 30, 2008, respectively. Currently over 95% of our rural telephone companies local access lines are DSL-capable.

In addition to our access line, DSL and video initiatives, we intend to continue to integrate best practices across our markets. We also continue to look for ways to enhance current products and introduce new services to ensure that we remain competitive and continue to meet our customers needs. These initiatives may include offering:

- hosted digital telephone service in certain Texas and Pennsylvania markets to meet the needs of small- to medium-sized business customers that want robust functionality without having to purchase a traditional key or PBX phone system;
- Digital telephone service for residential customers, which is being offered to our customers as a growth opportunity and as an alternative to the traditional phone line for customers who are considering a switch to a cable competitor. Since we began to more aggressively promote our digital telephone service in situations in which we are attempting to save or win back customers, we estimate that the product has allowed us to reduce our residential customer loss by 10%.
- DSL service even to users who do not have our access line which expands our customer base and creates additional revenue-generating opportunities;
- a DSL product with speeds up to 20 Mbps for those customers desiring greater Internet speed; and
- High definition video service and digital video recorders in all of our IPTV markets.

We also utilize service bundles, which include combinations of local service, custom calling features, and Internet access, to generate revenue and retain customers. Our service bundles totaled 57,508, 42,054 and 43,902 at September 30, 2009, December 31, 2008 and September 30, 2008, respectively. Service bundles at September 30, 2009 include 17,152 units from our Pennsylvania market. Pennsylvania units are not included in

service bundle totals prior to September 30, 2009. As a result of converting the North Pittsburgh ILEC billing function to our legacy system in the second quarter of 2009, we are now able to quantify service bundles for our Pennsylvania market.