

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion should be read together with the Consolidated Financial Statements of Interactive and the notes thereto included elsewhere in this Annual Report.

RESULTS OF OPERATIONS

Overview

Interactive has grown primarily through the selective acquisition of rural local exchange carriers ("RLECs") and by offering additional services such as Internet service, alarm services, long distance service and competitive local exchange carrier ("CLEC") service. The Company's fifteen telephone companies, which range in size from approximately 800 to over 10,000 access lines are located in California, Iowa, Kansas, Michigan, New Hampshire, New Mexico, New York, North Dakota, Utah and Wisconsin.

The telecommunications industry in general and the RLECs that comprise Interactive's business face a number of economic or industry-wide issues and challenges.

- *Regulatory-* The Telecommunications Act of 1996 and other federal and state legislation and regulations have a significant impact on the industry and on rural carriers in particular. Interactive's telephone companies are all RLECs serving very high cost areas with a significant portion of their revenues being derived from federal or state support mechanisms, which are referred to as Universal Service Funds ("USF"). The revenues and margins of our RLEC subsidiaries are largely dependent on the continuation of such support mechanisms.
- *Competition-* The effects of competition from CLECs, wireless service, high speed cable, Voice Over Internet Protocol ("VoIP") and other internet providers is an industry-wide issue that is felt to varying degrees by our rural telephone companies.
- *The economy-* Unemployment, building starts, business bankruptcies and the overall health of the economy have a significant effect on demand for our services.
- *Telecommunication bankruptcies-* Interactive's telephone companies have significant, normal course of business receivables from interexchange carriers, such as MCI or Global Crossings who filed for bankruptcy and, as a result, have been written-off. Additional bankruptcies could have a significant effect on our financial condition. The Company recovered settlements from MCI in 2005.
- *Market challenges-* Our phone companies are required to comply with industry-wide initiatives such as local number portability and the requirements of the Communications Assistance for Law Enforcement Act ("CALEA") that are expensive to implement and that in some cases have limited demand in our markets.

Interactive generates cash and earns telecommunications revenues primarily from local network access, intrastate and interstate access revenue and from state and federal USF support mechanisms. Due to the nature of the Company's regulated telephone operations, revenues and operating expenses are relatively stable period to period.

- *Local Revenues -* The number of access lines is the primary driver of local network access revenues. In addition, the ratio of business to residential lines, as well as the number of features subscribed to by customers are secondary drivers.

- Intrastate access revenues - Customer usage, primarily based on minutes of use, and the number of access lines are the primary drivers of intrastate access revenues since the Company's RLECs are on a "bill-and-keep" basis.
- National Exchange Carrier Association ("NECA") revenues - All of our RLECs participate in the NECA access pools. Interstate access revenues depend upon whether the RLEC has elected to be "cost-based" or has remained an "average schedule" carrier. The revenues of our ten cost-based carriers directly correlate to the rate-of-return on regulated net investment earned by the NECA access pools plus the amount of regulated operating expenses including taxes. The revenues of the Company's five average schedule subsidiaries correlate to usage based measurements such as access lines, interstate minutes-of-use, and the number and mileage of different types of circuits. The average schedule formulas are intended to be a proxy for cost-based recovery.
- USF subsidies - The primary drivers of USF subsidies are investments in specific types of infrastructure, as well as certain operating expenses and taxes of the Company. Interstate and intrastate USF subsidies are included in the respective interstate and intrastate access revenue captions in the breakdown of revenue and operating expenses which follows.
- Other business revenue - Interactive's companies also provide non-regulated telecommunications related services, including Internet access service, wireless and long distance resale service, in certain of its telephone service and adjacent areas. Interactive also provides and intends to provide more local telephone and other telecommunications service outside certain of its franchise areas by establishing CLEC operations in selected nearby areas. In addition, certain of Interactive's companies have expanded into cable and security businesses in the areas in which they operate.
- Long Distance revenues are only retained by the Company if it is providing the long distance service to the end user customer as the toll provider. For unaffiliated IXCs who contract with Interactive for billing services, the Company provides billing services and receives an administrative handling fee.

The following are material opportunities, challenges and risks that Interactive's executives are currently focused on, as well as actions that are being taken to address the concerns:

- Universal Service Reform - Efforts to modify universal service mechanisms at the FCC have been underway since 2004. In June 2004, the FCC asked the Federal-State Joint Board on Universal Service ("Joint Board") to review the rules relating to the high-cost universal service support mechanisms for rural carriers and to determine the appropriate rural mechanism to succeed the five-year plan adopted in the *Rural Task Force Order*. In particular, the FCC asked the Joint Board to make recommendations on a long-term universal service plan that ensures that support is specific, predictable, and sufficient to preserve and advance universal service. The FCC asked the Joint Board to ensure that its recommendations are consistent with the goal of ensuring that consumers in rural, insular, and high-cost areas have access to telecommunications and information services at rates that are affordable and reasonably comparable to rates charged for similar services in urban areas. The FCC also asked the Joint Board to consider how support can be effectively targeted to rural telephone companies serving the highest cost areas, while protecting against excessive fund growth. In conducting its review, the Joint Board is supposed to take into account the significant distinctions among rural carriers, and between rural and non-rural carriers and consider all options for determining appropriate universal service support. The Company participated with the RLEC industry in comments to the FCC regarding the potential impact to customers and RLECs in rural America. Total USF support payments are material to the Company's financial results.

- Intercarrier Compensation and Access Charge Reform - The Company is actively participating in the RLEC industry's efforts to determine how intercarrier compensation and access charges should be modified without causing revenue losses for RLECs.
- Loss of Access Revenues from VoIP and wireless usage - The Company is experiencing revenue losses as usage transfers from landline service provided by the Company's subsidiaries to either VoIP or wireless services. VoIP traffic currently does not pay access charges or contribute to universal service. The FCC has several proceedings underway to determine whether VoIP traffic should contribute for the use of the network and contribute to USF. The Company is participating in the RLEC industry efforts to have VoIP traffic contribute for use of the underlying network on which the VoIP call travels. To offset revenue losses from traditional voice services, Interactive is installing more broadband services and is exploring how to best incorporate VoIP into its business model.
- Intrastate revenue at our Michigan telephone company has been adversely affected by a state requirement to expand the local calling area. The Company filed and received approval in 2005 from the state commission to recover a portion of the revenue deficiency resulting from this change.

Year 2005 compared to 2004

The following is a breakdown of revenues and operating costs and expenses for 2005 and 2004 (in thousands):

	2005	2004	Impact of Cal-Ore Acquisition	Other Increase (Decrease)
	(Unaudited)			
Revenues:				
Local access	\$ 12,115	\$ 11,851	\$ 238	\$ 26
Interstate access	43,741	39,644	1,459	2,638
Intrastate access	14,638	15,263	491	(1,116)
Other business	23,171	21,036	488	1,647
Total	<u>93,665</u>	<u>87,794</u>	<u>2,676</u>	<u>3,195</u>
Operating Cost and Expense:				
Cost of revenue, excluding depreciation	34,266	29,992	690	3,584
General and administrative costs at operations	14,668	13,800	578	290
Corporate office expenses	7,858	6,401	-	1,457
Depreciation and amortization	21,803	21,870	610	(677)
Gain or sale of burglar alarm customers	(1,063)	-	-	(1,063)
Total	<u>77,532</u>	<u>72,063</u>	<u>1,878</u>	<u>3,591</u>
Operating profit	<u>\$ 16,133</u>	<u>\$ 15,731</u>	<u>\$ 798</u>	<u>\$ (396)</u>

Total revenues in 2005 increased \$5.9 million, or 6.7%, to \$93.7 million compared to \$87.8 million in 2004. The inclusion of Cal-Ore since August 29, 2005 added \$2.7 million to revenue as shown in the above table. The following explanations do not include the contributions to revenue from Cal-Ore. Local access revenue was relatively unchanged resulting from a 0.7% decrease in access lines offset by the sale of additional services and features. The decrease in access lines is due to the increase in cell phone usage and

reduction in second lines as customers switch from dial-up internet service to DSL. Interstate access revenue increased \$2.6 million in 2005 primarily due to a temporary increase in customer traffic in Utah. In addition, infrastructure development undertaken in 2002 and 2003, which entitled the Company to increased network access and USF support primarily at the Haviland Telephone Company in Kansas and the effects of 2005 investments resulted in increased network access revenue at our Michigan telephone company. Intrastate network access revenue decreased \$1.1 million due to a loss of toll revenue for dial-up access to the internet at our Michigan telephone company, the gradual phase-out of a New York pool for small carriers, and a reduction of minutes of use at several of our companies. Other business revenues increased \$1.6 million due to revenues from an acquisition of cable television assets that was completed in March 2005, as well as increased DSL penetration. In addition, other business revenue in the 2004 period included \$0.3 million due to the sale of telecommunications equipment to an Iowa school district.

Total costs and expenses increased by \$5.5 million to \$77.5 million in 2005. The inclusion of Cal-Ore since August 29, 2005 added \$1.9 million to cost as shown in the above table. The following explanations do not include the contributions to expense from Cal-Ore. Costs of revenue increased \$3.6 million, or 11.9%, due to costs generated by the cable television operations acquired in March 2005, additional operating costs related to the infrastructure development in Haviland and the 2005 spending in Michigan. In addition, it was effected by the absence of costs incurred in 2004 relating to the sale of equipment to the Iowa school district. General and administrative costs incurred at the operations increased \$0.3 million primarily due to increased costs relating to the Haviland infrastructure development, increased professional fees associated with the rate filing for the expanded local area calling in Michigan and increased audit fees. Corporate office expenses increased \$1.5 million primarily resulting from \$3.8 million of legal costs incurred defending the False Claims Act litigation in 2005 compared to \$3.3 million in 2004. In addition, the Company incurred legal and consulting costs in conjunction with a shareholder proposal to deregister as a public company. Depreciation and amortization decreased \$0.7 million including an increase of \$0.1 million in depreciation and a decrease of \$0.8 million of amortization expense. The decrease in amortization resulted from the Company's 2004 annual test of goodwill and other indefinite life intangible assets for impairment in accordance with SFAS No.142. Interactive recorded a \$0.7 million impairment of its investments in certain 10MHz PCS licenses in Las Cruces, NM and Logan, UT. Such impairment was based on a February 2005 FCC auction of similar spectrum in which the price per MHz of population was materially lower than the price Interactive paid for such spectrum. In addition, in 2004, \$0.5 million of goodwill was considered to be impaired and was written off in amortization expense compared to a write-off of \$0.3 million from the 2005 SFAS 142 test. In July 2005, the Company sold 62% of its burglar alarm customers resulting in a gain of \$1.1 million.

As a result of the above, operating profit in 2005 increased by \$0.4 million to \$16.1 million compared to 2004.

Adjusted operating profit

Adjusted operating profit is used by our management as a supplemental financial measure to evaluate the operating performance of our business that, when viewed with our GAAP results and the accompanying reconciliations, we believe provides a more complete understanding of factors and trends affecting our business than the GAAP results alone. We also regularly communicate our adjusted operating profit to the public through our earnings releases because it is the financial measure commonly used by analysts that cover the telecommunications industry and our investor base to evaluate our operating performance. In addition, we routinely use adjusted operating profit as a metric for valuing potential acquisitions. We understand that analysts and investors regularly rely on non-GAAP financial measures, such as adjusted operating profit, to provide a financial measure by which to compare a company's assessment of its operating performance against that of other companies in the same industry. This non-GAAP financial measure is helpful in more clearly reflecting the sales of our products and services, as well as highlighting trends in our core business that may not otherwise be apparent when relying solely on GAAP financial measures, because this non-GAAP financial measure eliminates from earnings financial items that have less bearing on our performance.

Interactive's management believes strongly in growing intrinsic value as a long-term prescription for managing an enterprises health. Our local management teams run their respective businesses as stand-alone, entrepreneurial units. We believe that adjusted operating profit is the clearest indicator of the cash flow generating ability and long-term health of such units. We value potential acquisitions on the same basis.

The term "adjusted operating profit" refers to, for any period, net income (loss) before all components of "Other income (expense)" (consisting of investment income, interest expense, equity in earnings of affiliates, gains and losses on disposition of or impairment of assets), income taxes, depreciation, amortization, minority interests and income or loss from discontinued operations.

Set forth below are descriptions of the financial items that have been excluded from net income (loss) to calculate adjusted operating profit and the material limitations associated with using this non-GAAP financial measure as compared to the use of the most directly comparable GAAP financial measure:

- The amount of interest expense we incur is significant and reduces the amount of funds otherwise available to use in our business and, therefore, is important for investors to consider. However, management does not consider the amount of interest expense when evaluating our core operating performance.
- Investment income is considered to be similar to interest expense. Although it is important for investors to consider, management does not consider the amount of investment income when evaluating our core operating performance.
- Management does not consider income tax expense when considering the profitability of our core operations. Nevertheless, the amount of taxes we are required to pay reduces the amount of funds otherwise available for use in our business and thus may be useful for an investor to consider.
- Depreciation and amortization are important for investors to consider, even though they are non-cash charges, because they represent generally the wear and tear on our property, plant and equipment, which produce our revenue. We do not believe these charges are indicative of our core operating performance.
- Income from equity investments relates to our proportionate share of income or loss from the entities in which we hold minority interests. We do not control these entities and, as such, do not believe the income we receive from such entities is indicative of our core operating performance.
- Minority interest in (income) loss of subsidiaries relates to our minority investors' proportionate share of income or losses in our non-wholly owned subsidiaries, which generated non-cash charges to our operating results. Operating results attributable to these minority investors' investments do not necessarily result in any actual benefit or detriment to us and, therefore, we believe it would be more helpful for an investor to exclude such items as being more reflective of our core operating performance.
- Gain or losses on the disposition of assets or impairment of investments may increase or decrease the cash available to us and thus may be important for an investor to consider. We are not in the business of acquiring or disposing of assets and, therefore, the effect of the dispositions of assets may not be comparable from year-to-year. We believe such gains or losses recorded on the disposition of an asset do not reflect the core operating performance of our business.

Management compensates for the above-described limitations of using a non-GAAP financial measure by using this non-GAAP financial measure only to supplement our GAAP results to provide a more complete

understanding of the factors and trends affecting our business. Adjusted operating profit should not be considered to be a substitute for net income or (loss) as an indicator of the Company's operating performance.

The following table provides the components of Adjusted Operating Profit and reconciles it to net income:

	2005	2004	Increase (Decrease)
Adjusted operating profit from:			
Operating units	\$ 45,794	\$ 44,002	\$ 1,792
Corporate expense:			
False Claims Act litigation	(3,780)	(3,250)	(530)
Other	(4,078)	(3,151)	(927)
Total corporate expenses	(7,858)	(6,401)	(1,457)
Adjusted operating profit	<u>\$ 37,936</u>	<u>\$ 37,601</u>	<u>\$ 335</u>
Reconciliation to net income:			
Adjusted operating profit	\$ 37,936	\$ 37,601	\$ 335
Depreciation and amortization	(21,803)	(21,870)	(67)
Investment income	2,180	1,474	706
Interest expense	(12,472)	(11,204)	(1,268)
Equity in income of affiliates	3,613	3,564	49
Income tax	(2,827)	(3,078)	251
Minority interests	(2,326)	(2,021)	(305)
Net income	<u>\$ 4,301</u>	<u>\$ 4,466</u>	<u>\$ (165)</u>

Other Income (Expense)

In 2005, investment income increased by \$0.7 million primarily due to an increase in CoBank patronage refunds and a \$0.1 million one time dividend from Iowa Network services. Included in 2004 is a gain from the sale of an investment.

Interest expense increased by \$1.3 million in 2005 compared to 2004 due primarily to the debt issued in conjunction with the Cal-Ore acquisition, higher borrowings on the Corporate line of credit, higher interest rates on variable rate borrowings, and partly offset by scheduled debt repayments.

Equity in earnings of affiliates in 2005 increased slightly due to consistently high earnings at the Company's New Mexico cellular investments (RSA 3 and 5).

Income Tax Provision

The income tax provision includes federal, as well as state and local taxes. The tax provision for 2005 and 2004, represent effective tax rates of 34.8% and 36.8%, respectively. The difference between these effective rates and the federal statutory rate is principally due to state income taxes, including the effect of earnings attributable to different state jurisdictions. In addition, in both December 2005 and 2004 Interactive reversed certain tax reserves that were no longer required.

Minority Interests

Minority interests decreased earnings by \$2.3 million in 2005, as compared to \$2.0 million in 2004. The change was due to higher earnings from the Company's New Mexico cellular investments.