

# SUREWEST COMMUNICATIONS (SURW)

## 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filed on 10/28/2011

Filed Period 09/30/2011

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

For the quarterly period ended September 30, 2011

or

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

Commission File Number 000-29660



**SureWest Communications**

(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction  
of incorporation or organization)

68-0365195  
(IRS Employer  
Identification No.)

8150 Industrial Avenue, Building A, Roseville, California  
(Address of principal executive offices)

95678  
(Zip Code)

(916) 786-6141  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant 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  No

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  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

On October 18, 2011, the registrant had 14,090,693 shares of Common Stock outstanding.



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## PART 1 – FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

**SUREWEST COMMUNICATIONS**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
*(Unaudited; Amounts in thousands, except per share amounts)*

	<u>Quarter Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
<b>Operating revenues:</b>				
Broadband	\$ 48,018	\$ 43,861	\$ 139,356	\$ 129,514
Telecom	14,979	17,256	45,158	52,339
Total operating revenues	<u>62,997</u>	<u>61,117</u>	<u>184,514</u>	<u>181,853</u>
<b>Operating expenses:</b>				
Cost of services and products (exclusive of depreciation and amortization)	28,566	26,672	81,352	78,771
Customer operations and selling	7,771	7,028	22,146	22,542
General and administrative	6,879	6,720	22,819	24,296
Depreciation and amortization	15,810	15,680	47,942	46,048
Total operating expenses	<u>59,026</u>	<u>56,100</u>	<u>174,259</u>	<u>171,657</u>
<b>Income from operations</b>	3,971	5,017	10,255	10,196
Other income (expense):				
Interest income	4	16	36	62
Interest expense	(2,497)	(2,311)	(9,512)	(6,189)
Other, net	(546)	10	(249)	(323)
Total other income (expense), net	<u>(3,039)</u>	<u>(2,285)</u>	<u>(9,725)</u>	<u>(6,450)</u>
Income before income taxes	932	2,732	530	3,746
Income tax expense	<u>289</u>	<u>1,328</u>	<u>211</u>	<u>2,342</u>
<b>Net income</b>	<u>\$ 643</u>	<u>\$ 1,404</u>	<u>\$ 319</u>	<u>\$ 1,404</u>
<b>Basic and diluted earnings per share</b>	<u>\$ 0.05</u>	<u>\$ 0.10</u>	<u>\$ 0.02</u>	<u>\$ 0.10</u>
<b>Shares of common stock used to calculate basic and diluted earnings per share:</b>				
Basic	<u>13,918</u>	<u>13,736</u>	<u>13,851</u>	<u>13,883</u>
Diluted	<u>14,023</u>	<u>13,736</u>	<u>13,944</u>	<u>13,883</u>
<b>Dividends declared per common share</b>	<u>\$ 0.08</u>	<u>\$ –</u>	<u>\$ 0.16</u>	<u>\$ –</u>

See accompanying notes.

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**SUREWEST COMMUNICATIONS**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
*(Unaudited; Amounts in thousands)*

	<u>September 30,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 8,932	\$ 2,937
Short-term investments	-	771
Accounts receivable, net	19,896	20,298
Income tax receivable	177	1,782
Prepaid expenses	2,875	3,792
Deferred income taxes	2,052	2,284
Assets held for sale	5,743	6,009
Total current assets	<u>39,675</u>	<u>37,873</u>
Property, plant and equipment, net	517,751	514,639
Intangible and other assets:		
Customer relationships, net	1,721	2,632
Goodwill	45,814	45,814
Deferred charges and other assets	5,031	2,223
	<u>52,566</u>	<u>50,669</u>
	<u>\$ 609,992</u>	<u>\$ 603,181</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of long-term debt	\$ 15,000	\$ 15,636
Accounts payable	2,349	2,885
Other accrued liabilities	17,217	12,847
Advance billings and deferred revenues	8,148	8,035
Accrued compensation	8,192	6,998
Total current liabilities	<u>50,906</u>	<u>46,401</u>
Long-term debt	191,250	189,773
Deferred income taxes	55,311	56,661
Accrued pension and other post-retirement benefits	34,960	33,815
Other liabilities and deferred revenues	5,978	4,473
Commitments and contingencies		
Shareholders' equity:		
Common stock, without par value; 100,000 shares authorized, 14,091 and 13,866 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	146,177	143,309
Accumulated other comprehensive loss	(16,359)	(15,081)
Retained earnings	141,769	143,830
Total shareholders' equity	<u>271,587</u>	<u>272,058</u>
	<u>\$ 609,992</u>	<u>\$ 603,181</u>

See accompanying notes.

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**SUREWEST COMMUNICATIONS**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
*(Unaudited; Amounts in thousands)*

	<b>Nine Months Ended September 30,</b>	
	<b>2011</b>	<b>2010</b>
Net cash provided by operating activities	\$ 61,189	\$ 46,509
Cash flows from investing activities:		
Capital expenditures for property, plant and equipment	(50,781)	(39,271)
Proceeds from sale of property and equipment	624	-
Proceeds from sale of available-for-sale securities	783	3,700
Purchases of available-for-sale securities	(10)	(28)
Proceeds from sale of discontinued operations	-	1,725
Net cash used in investing activities	<u>(49,384)</u>	<u>(33,874)</u>
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	170,000	8,069
Principal payments on long-term debt	(169,159)	(22,069)
Payment of debt issuance costs	(3,565)	-
Dividends paid	(2,256)	-
Repurchases and surrenders of common stock	(830)	(2,909)
Net cash used in financing activities	<u>(5,810)</u>	<u>(16,909)</u>
Increase (decrease) in cash and cash equivalents	5,995	(4,274)
Cash and cash equivalents at beginning of period	<u>2,937</u>	<u>7,489</u>
Cash and cash equivalents at end of period	<u>\$ 8,932</u>	<u>\$ 3,215</u>

See accompanying notes.

**SUREWEST COMMUNICATIONS**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
*(Unaudited; Amounts in thousands, except share and per share amounts)*

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Business and Basis of Accounting**

SureWest Communications (the "Company", "we" or "our") is a holding company with operating subsidiaries that provide communications services in Northern California, primarily the greater Sacramento region ("Sacramento region"), and the greater Kansas City, Kansas and Missouri areas ("Kansas City area"). Our operating subsidiaries are SureWest Broadband, SureWest TeleVideo, SureWest Kansas, Inc., ("SureWest Kansas" or the "Kansas City operations"), SureWest Telephone and SureWest Long Distance.

We expect that the sources of our revenues and our cost structure may be different in future periods, both as a result of our entry into new communications markets and competitive forces in each of the markets in which we have operations.

In the opinion of management, the accompanying condensed consolidated balance sheets and related interim statements of income and cash flows include all adjustments, consisting only of normal recurring items, necessary for their fair presentation in conformity with accounting principles generally accepted in the United States ("U.S. GAAP" or "GAAP") for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such SEC rules and regulations and accounting principles applicable for interim periods. Events subsequent to the balance sheet date have been evaluated for inclusion in the accompanying condensed consolidated financial statements through the date of issuance. Management believes that the disclosures made are adequate to make the information presented not misleading. Interim results are not necessarily indicative of results for a full year. The information presented in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto included in our 2010 Annual Report on Form 10-K filed with the SEC.

**Other Adjustments**

Our subsidiaries provide services to customers for which they are required to contribute to the universal service fund ("USF"). Each subsidiary collects USF fees from its customers and we remit these amounts to the Universal Service Administrative Company ("USAC"), the administrator of the Federal USF. SureWest Telephone provides wholesale transport services to SureWest Broadband, which SureWest Broadband resells to its own customers. The SureWest Broadband services are subject to USF fees. During the quarter ended June 30, 2011, we determined that SureWest Telephone remitted USF fees to USAC relating to the wholesale transport for voice services which it sells to SureWest Broadband for the year ended December 31, 2010 and the quarters ended March 31, 2011 and June 30, 2011. We also determined that SureWest Broadband had remitted USF fees to USAC relating to the voice services provided to its customers during the same time periods, including those services utilizing SureWest Telephone wholesale transport. Wholesale transport services provided by SureWest Telephone to SureWest Broadband for the resale as voice services are not subject to USF fees for SureWest Telephone generally because USF contributions are being collected from the end user customers of SureWest Broadband who use these resold wholesale services. Accordingly, in June 2011, SureWest Telephone filed an amended remittance form with USAC to recover \$906 of the fees paid for the year ended December 31, 2010. During the quarter ended September 30, 2011, USAC approved our amended filing and the USF fees are being refunded to SureWest Telephone monthly through the first quarter of 2012. The USF fees of \$303 and \$329 for the quarters ended March 31, 2011 and June 30, 2011, respectively, will be refunded to SureWest Telephone based on its annual remittance form to be filed with USAC during the first quarter of 2012. In addition, SureWest Broadband recorded a \$218 reduction to its USAC expense during the quarter ended June 30, 2011 relating to revised estimates to its interstate traffic that will be included in its annual remittance form to be filed with USAC in the first quarter of 2012. We expect to receive the refunds from the annual remittance filings during the third quarter of 2012. For the fees relating to 2010 and the quarter ended March 31, 2011, we recognized a

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reduction in operating expense (within costs of services and products) on the condensed consolidated statements of income of \$1,427 for the nine-month period ended September 30, 2011. This resulted in an increase to consolidated net income by \$856 (\$0.06 per share) for the nine months ended September 30, 2011 and a corresponding receivable of \$1,756 on the condensed consolidated balance sheets. We received repayment of \$307 from USAC during the third quarter of 2011 for the fees related to 2010 and expect to receive the remaining short-term receivable balance of \$1,449 by the end of the third quarter of 2012.

### Recent Developments

#### *Assets Held For Sale*

Assets held for sale consist of certain real estate assets that we have committed to sell or are currently marketed for sale. These regulated assets, which are included in the Telecommunications ("Telecom") segment, include 21 acres of undeveloped land and two office buildings.

The following is the carrying value of the assets held for sale as of September 30, 2011 and December 31, 2010:

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Undeveloped land	\$ 1,556	\$ 1,556
Office buildings	4,187	4,453
	<u>\$ 5,743</u>	<u>\$ 6,009</u>

In May 2011, we entered into an agreement to sell office facilities, which included developed land, an office building and vehicle parking structure, for a purchase price of \$1,900 and as a result, classified these assets as assets held for sale during the quarter ended June 30, 2011. In connection with the classification to assets held for sale, no impairment charge was recognized as the estimated fair value less selling costs exceeded the carrying value of the assets. The sale is expected to close by December 31, 2011. Upon the close of the sale, a gain of approximately \$560 will be recorded against accumulated depreciation, in accordance with regulated telephone plant and equipment composite group remaining life methodology. For the non-depreciable assets included in the sale, a gain of approximately \$235 will be recognized in the condensed consolidated statements of income upon the completion of the close of the sale.

In August 2011, we entered into an agreement to sell an office building included in assets held for sale for a purchase price of \$3,500. The sale is expected to close by the end of the second quarter of 2012. During the quarter ended September 30, 2011, the carrying value of the office building was reduced to its fair value less estimated selling costs. As a result, an impairment charge of \$1,210 was recorded against accumulated depreciation during the quarter ended September 30, 2011, in accordance with regulated telephone plant and equipment composite group remaining life methodology. For the non-depreciable assets included in the sale, an impairment loss of \$43 was recognized in the condensed consolidated statements of income during the quarter ended September 30, 2011.

### Recently Issued Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board ("FASB") issued the Accounting Standards Update ("ASU") to permit an entity the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the first step of the two-step goodwill impairment test. Accordingly, based on the option created by the amended guidance, the calculation of a reporting unit's fair value is not required unless, as a result of the qualitative assessment, it is more likely than not that fair value of the reporting unit is less than its carrying amount. The amended guidance, which should be applied prospectively, becomes effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. We are currently evaluating the impact this update will have on our condensed consolidated financial statements.

In May 2011, as part of ongoing efforts with the International Accounting Standards Board to achieve convergence, the FASB issued the ASU on fair value measurements and disclosures to (i) clarify the application of existing fair value measurement and disclosure requirements and (ii) change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements. The amendments in this ASU are effective for public entities for interim and annual periods beginning after December 15, 2011 and should be applied prospectively, with early application not permitted. We are currently evaluating the impact this update will have on our condensed consolidated financial statements.

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In June 2011, the financial statement presentation of comprehensive income was amended by an ASU issued by the FASB to (i) eliminate the option to present the components of other comprehensive income ("OCI") in the statement of changes in stockholder's equity, (ii) require presentation of net income and OCI and their respective components either in a single continuous statement or in two separate but consecutive statements and (iii) require presentation of reclassification adjustments on the face of the statement. The amendments in this ASU do not change (i) the items that must be reported in OCI or when an item of OCI must be reclassified to net income or (ii) the option for an entity to present components of OCI either net of related tax effects or before related tax effects. Amendments to comprehensive income should be applied retrospectively and become effective for public entities for interim and annual periods beginning after December 15, 2011 with early adoption permitted. We are currently evaluating the impact this update will have on our condensed consolidated financial statements.

### **Recently Adopted Accounting Pronouncements**

On January 1, 2011, we adopted the ASU regarding business combinations. The updated guidance requires a public entity to disclose pro forma revenue and earnings for a business combination occurring in the current year as though the business combination occurred as of the beginning of the year or, if comparative statements are presented, pro forma amounts are required to be presented as though the business combination took place as of the beginning of the comparative year. In addition, it also expands the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The provisions of this updated guidance will be applied prospectively to business combinations consummated subsequent to January 1, 2011. Our adoption of this guidance did not impact our condensed consolidated financial position or results of operations.

On January 1, 2011, we prospectively adopted the ASU that clarifies when the circumstances under which step 2 of the goodwill impairment test must be performed for reporting units with zero or negative carrying amounts and the qualitative factors to be taken into account when performing step 2 in determining whether it is more likely than not that an impairment exists. The adoption of this guidance did not impact our condensed consolidated financial position or results of operations.

On January 1, 2011, we prospectively adopted the ASU regarding revenue recognition for multiple-deliverable arrangements. The updated guidance provides for a new methodology for establishing the fair value for a deliverable in a multiple-element arrangement. When vendor specific objective or third-party evidence for deliverable in a multiple-element arrangement cannot be determined, an enterprise is required to develop a best estimate of the selling price of separate deliverables and to allocate the arrangement consideration using the relative selling price method. The adoption of this guidance did not have a material impact on our condensed consolidated financial position or results of operations.

### **Earnings and Dividends Per Share**

Basic earnings (loss) per share is computed by dividing the net income (loss) applicable to common stockholders by the weighted average number of common shares outstanding during the period.

Diluted earnings (loss) per share ("diluted EPS") is computed based on the weighted average number of common shares plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include time and performance based stock awards and stock units. Diluted EPS excludes the impact of potential common shares related to our stock options in periods where the option exercise price is greater than the average market price of our common stock.

Diluted EPS for the three and nine-month periods ended September 30, 2010 exclude potential common shares because their inclusion would have had an anti-dilutive effect.

Cash dividends per share are based on the actual dividends per share, as declared by the Company's Board of Directors. On each date that the Company pays a cash dividend to the holders of the Company's common stock, the Company credits to the holders of restricted stock units and performance share units (collectively "stock units") an additional number of stock units equal to the total number of whole stock units and additional stock units previously credited to the holders, multiplied by the dollar amount of the cash dividend per share of common stock. Any fractional stock units resulting from such calculation are included in the additional stock units.

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### 2. FAIR VALUE MEASUREMENTS & FINANCIAL INSTRUMENTS

#### Investments

The following is a summary of our short-term available-for-sale investments as of December 31, 2010:

	<u>As of December 31, 2010</u>			
		<b>Gross</b>	<b>Gross</b>	<b>Estimated</b>
	<b>Adjusted</b>	<b>Unrealized</b>	<b>Unrealized</b>	<b>Fair</b>
	<b>Cost</b>	<b>Gains</b>	<b>Losses</b>	<b>Market</b>
			<b>Value</b>	
Equity securities	\$ 727	\$ 44	\$ –	\$ 771

During the quarter ended March 31, 2011, we sold our short-term available-for-sale investments and we recognized a gain of approximately \$103 in other income (expense), other, net on the condensed consolidated statements of income.

#### Cost Method Investments

Cost method investments are originally recorded at cost, and we record dividend income or patronage income when they are declared. Cost method investments are reported as other long-term assets in our condensed consolidated balance sheets. Dividend income is reported in other income (expense), interest income in our condensed consolidated statements of income and patronage income is reported against other income (expense), interest expense in our condensed consolidated statements of income. We held \$1,430 and \$1,115 in cost method investments which were included in other long-term assets in the condensed consolidated balance sheets as of September 30, 2011 and December 31, 2010, respectively. Our cost method investments primarily consist of our investment in CoBank, ACB ("CoBank") and are related to patronage distributions of restricted equity. Our investment in CoBank is required in accordance with the provisions of our Credit Agreement (see Note 3) held by CoBank. We review all of our cost method investments quarterly to determine if impairment indicators are present; however, we are not required to determine the fair value of these investments unless impairment indicators exist. We estimate that the fair value of our cost method investments approximates their carrying values as of September 30, 2011 and December 31, 2010.

#### Fair Value of Financial Instruments

We account for certain assets and liabilities at fair value. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or a liability. A financial asset or liability's classification within a three-tiered value hierarchy is determined based on the lowest level input that is significant to the fair value measurement. The hierarchy prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 – Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – Inputs that reflect quoted prices in active markets for similar assets or liabilities, quoted prices for identical or similar assets or liabilities in inactive markets and inputs other than quoted prices that are directly or indirectly observable in the marketplace.

Level 3 – Unobservable inputs which are supported by little or no market activity.

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The following tables summarize our financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2011 and December 31, 2010:

	<b>As of September 30, 2011</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
<b>Assets</b>				
Interest rate caps	\$ 62	\$ –	\$ 62	\$ –
<b>Liabilities</b>				
Interest rate swap	\$ 1,755	\$ –	\$ 1,755	\$ –
	<b>As of December 31, 2010</b>			
	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Money market funds	\$ 84	\$ 84	\$ –	\$ –
Equity securities	771	771	–	–
	\$ 855	\$ 855	\$ –	\$ –

Fair values for cash equivalents were determined by quoted market prices. Fair values for interest rate caps and interest rate swaps are valued using models based on readily observable market parameters for all substantial terms and are classified within Level 2. See Note 4 for further discussion regarding our interest rate caps and interest rate swap.

### Fair Value of Debt

We had no short-term borrowings as of September 30, 2011 and December 31, 2010. The fair value of our long-term debt was estimated using discounted cash flow analyses based on incremental borrowing rates for similar types of borrowing arrangements.

	<b>As of September 30, 2011</b>		<b>As of December 31, 2010</b>	
	<b>Carrying Value</b>	<b>Fair Value</b>	<b>Carrying Value</b>	<b>Fair Value</b>
Long-term debt (including current maturities)	\$ 206,250	\$ 204,301	\$ 205,409	\$ 203,459

### 3. CREDIT ARRANGEMENTS

A summary of our long-term debt is as follows:

	<b>Weighted Average Interest Rates</b>			<b>September 30, 2011</b>	<b>December 31, 2010</b>
	<b>September 30, 2011</b>	<b>December 31, 2010</b>	<b>Maturity Date</b>		
Secured Term Loan B credit facility	3.63%	–	March 2016	\$ 206,250	\$ –
Unsecured Series A Senior Notes	–	6.30%	–	–	10,909
Unsecured Series B Senior Notes	–	4.74%	–	–	36,000
Unsecured Revolving Loan credit facility	–	2.56%	–	–	8,500
Unsecured Term Loan A credit facility	–	3.97%	–	–	120,000
Unsecured Term Loan B credit facility	–	2.56%	–	–	30,000
Total long-term debt				206,250	205,409
Less current portion				15,000	15,636
Total long-term debt, net of current				\$ 191,250	\$ 189,773

In March 2011, we entered into a \$264,000 five-year senior secured Credit Agreement ("Credit Agreement") to replace our unsecured Third Amended and Restated Credit Agreement ("Previous Agreement") from September 2008. The proceeds from the Credit Agreement were used to repay the Previous Agreement in its entirety and to repay the unsecured Series A and Series B Senior Notes issued in December 1998 and March 2003, respectively.

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The Credit Agreement included (i) a \$34,000 Revolving Loan Facility, which includes a \$6,000 swingline loan commitment and a \$5,000 commitment for the issuances of letters of credit, each as a subfacility to the Revolving Loan Facility, (ii) a fully drawn \$40,000 Term A Loan Facility and (iii) a \$190,000 Term Loan B Commitment. On May 31, 2011, the Term Loan A Facility matured and converted to a Term Loan B borrowing thus increasing the Term Loan B Commitment by \$40,000 to \$230,000. The Term Loan B Commitment includes a delayed draw amount which allows for one or more additional advances not to exceed \$20,000. The delayed draw may be used solely for capital expenditures. All amounts outstanding on the Revolving Loan Facility and the Term Loan B Facility will be due on March 2, 2016. As of September 30, 2011, no amounts were outstanding under the Revolving Loan facility.

In connection with entering into the Credit Agreement, we incurred \$3,565 in debt issuance costs of which \$301 were recognized during the quarter ended March 31, 2011. The remaining deferred debt issuance costs will be amortized over the term of the Credit Agreement. In addition, we incurred early termination fees of \$2,346 related to the repayment of our Series A and Series B Senior Notes during the quarter ended March 31, 2011. The early termination fees and the debt issuance costs expensed were recognized in other income (expense), interest expense in the condensed consolidated statements of income during the nine-month period ended September 30, 2011.

Commencing on September 30, 2011, and on the last day of each quarter thereafter, principal payments for the Term Loan B Facility are due in equal quarterly amounts of \$3,750. In addition, we must make mandatory repayments under certain circumstances upon receipt of proceeds from insurance, asset dispositions, debt issuances and equity issuances.

At September 30, 2011, the aggregate maturities of long-term debt were (i) \$3,750 in 2011, (ii) \$15,000 annually in 2012 through 2015 and (iii) \$142,500 in 2016 for a total of \$206,250.

Borrowings under the Credit Agreement (other than the swingline loan) will bear interest based, at our election, on the London Interbank Offered Rate ("LIBOR") or the bank's base rate in either case, plus an applicable margin based on our leverage ratio. The swingline loan will accrue interest at the base rate, plus an applicable margin.

Our obligations under the Credit Agreement are secured by a first priority security interest in essentially all our current and future assets. Security includes the capital stock we own or should acquire in all of our subsidiaries.

The Credit Agreement includes financial and operating covenants that may limit the incurrence of additional indebtedness, investments, the payment of dividends, the making of certain other restricted payments, transactions with affiliates, liens, mergers, asset sales and material changes in our business. The Credit Agreement also requires us to maintain certain financial ratios and minimum levels of tangible net worth.

Our financial covenants as defined in the Credit Agreement, measured quarterly, are as follows:

<u>Financial Covenant</u>	<u>Required Ratio Level</u>	<u>Actual Performance at September 30, 2011</u>
Leverage ratio	Not more than 3.00	2.44
Interest coverage ratio	Not less than 3.50	7.24
Consolidated net worth	Not less than \$200,000	\$287,946

## **4. DERIVATIVES**

We use derivative instruments to manage our interest rate exposure associated with our variable-rate debt and to achieve a desired proportion of fixed and variable-rate debt. At the inception of a hedge transaction, we formally document the relationship between the hedging instruments including our objective and strategy for establishing the hedge. In addition, the effectiveness of the derivative instrument is assessed at inception and on an ongoing basis. Counterparties to derivative instruments expose us to credit related losses in the event of nonperformance. We execute agreements only with financial institutions we believe to be creditworthy and regularly assess the creditworthiness of each of the counterparties. We do not use derivative instruments for trading or speculative purposes.

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All derivative instruments are recorded at fair value in the condensed consolidated balance sheet. For derivatives designated as a cash flow hedge, the effective portion of the change in the fair value is recognized as a component of accumulated other comprehensive loss. The change in fair value related to the ineffective portion of the hedge, if any, is immediately recognized as interest expense in the condensed consolidated statement of income. Amounts in accumulated other comprehensive loss will be reclassified to earnings when the related hedged items impact earnings. Cash flows from derivative instruments are classified in operating activities in the condensed consolidated statement of cash flows, which is consistent with the items being hedged.

In June 2011, we entered into an interest rate swap agreement and two interest rate cap agreements. These agreements have been designated as cash flow hedges. The swap agreement is on a notional amount of \$75,000 with a fixed rate of 1.85%. This fixes the total interest expense on \$75,000 of our outstanding long-term debt at 5.10%, which includes the fixed rate of 185 basis points plus our applicable interest margin of 325 basis points. The interest rate swap agreement is effective June 30, 2011 and ends March 2, 2016 with a cancellation provision on June 30, 2014. The interest rate swap agreement contains standard credit-risk-related contingent features which could result in the counterparty requesting termination and immediate settlement of the contract in the event of default.

The interest rate cap agreements each have a notional amount of \$25,000 with a 2.00% strike price and are effective June 30, 2011 through June 30, 2014 and August 31, 2011 through March 2, 2014, respectively. In June 2011, we paid premiums of \$333 to enter into the interest rate cap agreements. The premiums are being amortized to interest expense over the term of the agreement.

Fair values of derivative instruments in the condensed consolidated balance sheet at September 30, 2011 consisted of:

	<u>Classification</u>	<u>Fair Value</u>
<b><u>Asset derivatives</u></b>		
Interest rate caps	Deferred charges and other assets	\$ 62
<b><u>Liability derivatives</u></b>		
Interest rate swap	Other liabilities and deferred revenues	\$ 1,755

We did not have any derivative instruments at December 31, 2010.

The effect of derivative instruments on the condensed consolidated statements of income for the quarter and nine-month period ended September 30, 2011 consisted of:

	<u>Classification</u>	<u>Quarter and Nine Months Ended September 30, 2011</u>
<b><u>Interest rate caps</u></b>		
Loss recognized in other comprehensive income (effective portion)	Accumulated other comprehensive loss	\$ (271)
<b><u>Interest rate swap</u></b>		
Loss recognized in other comprehensive income (effective portion)	Accumulated other comprehensive loss	\$ (1,755)
Loss reclassified from accumulated other comprehensive income into income (effective portion)	Interest Expense	\$ (307)

We expect to reclassify \$1,125 of the net loss included in accumulated other comprehensive loss into earnings during the next 12 months.

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### 5. EQUITY

#### Share-Based Compensation

##### *Stock Plan*

Our Board of Directors may grant share-based awards from our shareholder approved Equity Incentive Plan, the 2000 Equity Incentive plan (the "Stock Plan"), to certain employees, outside directors and consultants. The Stock Plan permits issuance of awards in the form of restricted shares, stock units, performance shares, options or stock appreciation rights. Under the Stock Plan, approximately 2.2 million shares of our common stock are authorized for issuance, including those outstanding as of September 30, 2011.

##### *Time Based Stock Awards and Units*

We measure the fair value of time-based restricted stock awards ("RSAs") and restricted stock units ("RSUs") based upon the market price of the underlying common stock as of the date of the grant. RSAs and RSUs are amortized over their respective vesting periods, generally from immediate vest to a four-year vesting period using the straight-line method. We have estimated expected forfeitures based on historical experience and are recognizing compensation only for those RSAs and RSUs expected to vest.

The following table summarizes the grants of time-based RSAs and RSUs that occurred under the Stock Plan during the nine-month periods ended September 30, 2011 and 2010. No RSAs or RSUs were granted during the quarters ended September 30, 2011 and 2010.

	<b>Nine Months Ended September 30,</b>			
	<b>2011</b>	<b>Grant Date Fair Value</b>	<b>2010</b>	<b>Grant Date Fair Value</b>
RSAs Granted	212,654	\$ 12.00	217,575	\$ 9.95
RSUs Granted	78,614	\$ 10.78	92,709	\$ 9.95
Total	<u>291,268</u>		<u>310,284</u>	

The following summarizes the time-based RSA and RSU stock activity during the nine-month period ended September 30, 2011:

	<b>Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Nonvested-January 1, 2011	396,343	\$11.17
Granted	291,268	\$11.67
Vested	(191,937)	\$11.32
Forfeited	—	
Nonvested-September 30, 2011	<u>495,674</u>	\$11.40

The total fair value of the RSAs and RSUs that vested during the nine-month period ended September 30, 2011 was \$2,174.

##### *Performance Share Awards and Units*

We derive the fair value of performance share awards ("PSAs") and performance share units ("PSUs") (collectively "the awards") using the Monte Carlo Simulation ("MCS") valuation method. The MCS utilizes multiple input variables to determine the probability of the Company achieving the market condition and the derived fair value of the awards. PSAs and PSUs are generally granted in six vesting tranches over a vesting period ranging from thirty to thirty-five months. The awards vest based on the achievement of stock price appreciation and continuous employee service over the life of the award. As of each vesting date, each tranche vests if the average closing stock price of the SureWest common stock for the eleven trading day period, beginning five days before the corresponding target date and ending five days after the corresponding target date, is equal to or exceeds the respective target stock price. If the tranche does not meet the target stock price condition on its corresponding target date, then it may vest at a subsequent target date if the stock price condition is met. However, the tranche may not vest earlier than its corresponding target date. The fair values of the awards are amortized over the derived service period of each vesting tranche. We have estimated expected forfeitures based on historical experience and are recognizing compensation only for those PSAs and PSUs expected to vest.

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The following table summarizes the grants of PSAs and PSUs that occurred under the Stock Plan during the nine-month period ended September 30, 2011. No PSAs or PSUs were granted during the quarter ended September 30, 2011 or the quarter and nine-month period ended September 30, 2010.

	<u>Nine Months Ended September 30, 2011</u>	
	<u>Shares Granted</u>	<u>Fair Value</u>
PSAs	73,012	\$ 9.68
PSUs	19,712	\$ 8.32
Total	<u>92,724</u>	

The following table summarizes the PSA and PSU activity during the nine-month period ended September 30, 2011:

	<u>Shares</u>	<u>Weighted Average Grant Date Fair Value</u>
Nonvested-January 1, 2011	—	
Granted	92,724	\$ 9.39
Vested	(13,828)	\$ 10.22
Forfeited	(6,764)	\$ 8.06
Nonvested-September 30, 2011	<u>72,132</u>	\$ 9.36

The total fair value of the PSAs and PSUs that vested during the nine-month period ended September 30, 2011 was \$141.

### Share Based Compensation Expense

The following table summarizes total compensation costs recognized for share-based payments during the quarters and nine-month periods ended September 30, 2011 and 2010:

	<u>Quarter Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
RSAs <sup>(1)</sup>	\$ 438	\$ 109	\$ 2,377	\$ 1,526
RSUs	\$ 181	\$ 158	\$ 765	\$ 685
PSAs	\$ 108	\$ —	\$ 338	\$ —
PSUs	\$ 20	\$ —	\$ 94	\$ —
Total	<u>\$ 747</u>	<u>\$ 267</u>	<u>\$ 3,574</u>	<u>\$ 2,211</u>

<sup>(1)</sup> Pursuant to a severance agreement entered into on March 31, 2011 between the Company and a retiring officer, share-based compensation expense recognized during the nine months ended September 30, 2011 included approximately \$859 related to the acceleration of unvested, time-based RSAs.

As of September 30, 2011, total unrecognized compensation costs related to nonvested RSAs, RSUs, PSAs, and PSUs was \$5,151 and will be recognized over a weighted-average period of approximately 2.33 years.

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### Other Comprehensive Income

Significant components of our other comprehensive income are as follows:

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net income	\$ 643	\$ 1,404	\$ 319	\$ 1,404
Available-for-sale investments:				
Unrealized gain (loss) on available-for-sale investments, net of tax	-	56	(3)	(2)
Reclassification adjustment for gain included in net loss, net of tax	-	-	(57)	-
Derivative instruments designated as cash flow hedges:				
Unrealized loss on cash flow hedges, net of tax	(1,218)	-	(1,218)	-
Comprehensive income (loss)	<u>\$ (575)</u>	<u>\$ 1,460</u>	<u>\$ (959)</u>	<u>\$ 1,402</u>

### 6. PENSION PLAN AND OTHER POST-RETIREMENT BENEFITS

We maintain a frozen noncontributory defined benefit pension plan (the "Pension Plan") which covers certain eligible employees. Benefits are based on years of service and the employee's average compensation during the five highest consecutive years of the last ten years of credited service. Our funding policy is to contribute annually an actuarially determined amount consistent with applicable federal income tax regulations. Contributions are intended to provide for benefits attributed to service to date. Pension Plan assets are primarily invested in domestic equity securities, fixed income and international equity securities.

We also maintain an unfunded Supplemental Executive Retirement Plan ("SERP"), which provides supplemental retirement benefits to certain of our retired executives. The SERP provides for incremental pension payments to partially offset the reduction in amounts that would have been payable under the Pension Plan if it were not for limitations imposed by federal income tax regulations.

In addition, we provide certain post-retirement benefits other than pensions ("Other Benefits Plan") to certain eligible employees of our California location, including life insurance benefits and a stated reimbursement for Medicare supplemental insurance.

Effective April 1, 2007, we amended our Pension Plan, SERP and Other Benefits Plan (collectively the "Plans") such that the Plans were frozen so that no person is eligible to become a new participant on or following that date and all future benefit accruals for existing participants under the Plans cease.

#### Components of Net Periodic Pension Cost

The following table summarizes the benefit costs related to our Pension and SERP Plans:

	2011	2010
<b>Quarter Ended September 30,</b>		
Interest cost on projected benefit obligation	\$ 1,751	\$ 1,792
Expected return on plan assets	(1,865)	(1,820)
Amortization of:		
Prior Service Cost	-	1
Net actuarial loss	623	543
Net periodic pension expense	<u>\$ 509</u>	<u>\$ 516</u>
<b>Nine Months Ended September 30,</b>		
Interest cost on projected benefit obligation	\$ 5,252	\$ 5,376
Expected return on plan assets	(5,996)	(5,460)
Amortization of:		
Prior service cost	-	2
Net actuarial loss	1,870	1,630
Net periodic pension expense	<u>\$ 1,526</u>	<u>\$ 1,548</u>

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Net periodic benefit costs related to the Other Benefits Plan were not significant to our condensed consolidated financial statements for the quarters or nine-month periods ended September 30, 2011 and 2010.

### 7. INCOME TAXES

Our effective federal income tax rates were 39.8% and 62.5% for the nine-month periods ended September 30, 2011 and 2010, respectively. For the nine-month period ended September 30, 2011, our actual tax expense differed from the federal statutory rate primarily due to state taxes, permanent differences resulting from favorable tax treatment of dividends both paid and received and the release of unrecognized tax benefits. These favorable differences were offset by a change to state deferred tax expense attributable to apportionment changes.

Our policy is to recognize interest and penalties related to uncertain tax positions as additional income tax expense. We did not accrue significant amounts of interest and penalties related to unrecognized tax benefits during the nine-month periods ended September 30, 2011 and 2010.

The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$98 and \$176 at September 30, 2011 and December 31, 2010, respectively. We recognized \$110 of previously unrecognized tax benefits during the third quarter of 2011 as a result of the expiration of the statute of limitations.

As of September 30, 2011, the following tax years and related taxing jurisdictions were open:

<u>Tax Year</u>	<u>Taxing Jurisdiction</u>
2008 - 2010	Federal
2006 - 2010	California
2006 - 2010	Kansas and Missouri

### 8. BUSINESS SEGMENTS

We have two reportable business segments: Broadband and Telecom. We have aggregated certain of our operating segments within the Broadband and Telecom segments because we believe that such operating segments share similar economic characteristics. We measure and evaluate the performance of our segments based on income (loss) from operations. Corporate Operations are allocated to the appropriate segment, except for cash; investments; certain property, plant, and equipment; and miscellaneous other assets, which are not allocated to the segments. However, the interest income associated with cash and investments held by Corporate Operations is included in the results of the operations of our segments.

Our business segment information is as follows:

	<u>Broadband</u>	<u>Telecom</u>	<u>Intercompany Eliminations</u>	<u>Consolidated</u>
<b>For the three months ended September 30, 2011:</b>				
Operating revenues from external customers	\$ 48,018	\$ 14,979	\$ -	\$ 62,997
Intersegment revenues	152	5,231	(5,383)	0
Operating expenses				
Cost of services and products*	27,407	5,898	(4,739)	28,566
Customer operations and selling	5,624	2,667	(520)	7,771
General and administrative	4,148	2,855	(124)	6,879
Depreciation and amortization	12,574	3,236	-	15,810
Income (loss) from operations	(1,583)	5,554	-	3,971
Net income (loss)	\$ (2,801)	\$ 3,444	\$ -	\$ 643

\*Exclusive of depreciation and amortization

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	<u>Broadband</u>	<u>Telecom</u>	<u>Intercompany Eliminations</u>	<u>Consolidated</u>
<b>For the three months ended September 30, 2010:</b>				
Operating revenues from external customers	\$ 43,861	\$ 17,256	\$ –	\$ 61,117
Intersegment revenues	110	5,275	(5,385)	–
Operating expenses				
Cost of services and products*	25,719	5,677	(4,724)	26,672
Customer operations and selling	4,940	2,621	(533)	7,028
General and administrative	3,645	3,203	(128)	6,720
Depreciation and amortization	12,609	3,071	–	15,680
Income (loss) from operations	(2,942)	7,959	–	5,017
Net income (loss)	\$ (3,082)	\$ 4,486	\$ –	\$ 1,404

\*Exclusive of depreciation and amortization

	<u>Broadband</u>	<u>Telecom</u>	<u>Intercompany Eliminations</u>	<u>Consolidated</u>
<b>For the nine months ended September 30, 2011:</b>				
Operating revenues from external customers	\$ 139,356	\$ 45,158	\$ –	\$ 184,514
Intersegment revenues	467	15,579	(16,046)	–
Operating expenses				
Cost of services and products*	79,741	15,716	(14,105)	81,352
Customer operations and selling	15,995	7,716	(1,565)	22,146
General and administrative	13,404	9,791	(376)	22,819
Depreciation and amortization	38,360	9,582	–	47,942
Income (loss) from operations	(7,677)	17,932	–	10,255
Net income (loss)	\$ (10,212)	\$ 10,531	\$ –	\$ 319

\*Exclusive of depreciation and amortization

	<u>Broadband</u>	<u>Telecom</u>	<u>Intercompany Eliminations</u>	<u>Consolidated</u>
<b>For the nine months ended September 30, 2010:</b>				
Operating revenues from external customers	\$ 129,514	\$ 52,339	\$ –	\$ 181,853
Intersegment revenues	423	15,285	(15,708)	–
Operating expenses				
Cost of services and products*	75,008	17,407	(13,644)	78,771
Customer operations and selling	16,886	7,320	(1,664)	22,542
General and administrative	13,550	11,146	(400)	24,296
Depreciation and amortization	36,929	9,119	–	46,048
Income (loss) from operations	(12,436)	22,632	–	10,196
Net income (loss)	\$ (11,071)	\$ 12,475	\$ –	\$ 1,404

\*Exclusive of depreciation and amortization

## 9. REGULATORY MATTERS

Certain of our interstate telecommunications service rates are subject to regulation by the Federal Communications Commission ("FCC"). Interstate switched and special access rates are established through a SureWest Telephone tariff filed with the FCC. For interstate common line ("CL") charges, SureWest Telephone concurs with tariffs filed by the National Exchange Carrier Association ("NECA"). Intrastate service rates are subject to regulation by state commissions. Prices for intrastate telecommunications services are established through tariffs or through other

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regulatory mechanisms, including service guides in California. Pending and future regulatory actions may have a material impact on our consolidated financial position and results of operations.

### *FCC Matters*

Under current FCC rules governing rate making, SureWest Telephone is required to establish rates for its interstate telecommunications services based on projected demand usage for the various services. SureWest Telephone projects its earnings through the use of annual cost separation studies, which utilize estimated total cost information and projected demand usage. Carriers are required to follow FCC rules in the preparation of these annual studies. SureWest Telephone determines actual earnings from its interstate rates as actual volumes and costs become known. The FCC monitors SureWest Telephone's interstate earnings.

### *California Public Utility Commission ("CPUC") Matters*

A CPUC decision in August 2005 allowed SureWest Telephone to continue receiving our \$11,500 annual draw from the California High Cost Fund ("CHCF") on an interim basis pending further CPUC action. The CHCF was previously authorized by the CPUC to offset SureWest Telephone's intrastate regulated operating expenses on an interim basis. In August 2006, we requested permission from the CPUC to implement a graduated phase-down of our annual \$11,500 interim draw. In September 2007, the CPUC issued Decision 07-09-002 which provides for SureWest Telephone to phase-down its interim annual CHCF draw over a five-year period. The phase-down of the interim draw began in January 2007, initially reducing the annual \$11,500 interim draw to \$10,200, and in each subsequent year will be incrementally reduced by \$2,040. In 2010, our interim CHCF draw was \$4,080 and for 2011 is \$2,040.

In an ongoing proceeding relating to the New Regulatory Framework (under which SureWest Telephone has been regulated since 1996), the CPUC adopted Decision 06-08-030 in 2006, which grants carriers broader pricing freedom in the provision of telecommunications services, bundling of services, promotions and customer contracts. This decision adopted a new regulatory framework, the Uniform Regulatory Framework ("URF"), which among other things (i) eliminates price regulation and allows full pricing flexibility for all new and retail services except basic residential services, which limits increases to \$3.25 per year during 2009 and 2010, (ii) allows new forms of bundles and promotional packages of telecommunication services, (iii) allocates all gains and losses from the sale of assets to shareholders and (iv) eliminates almost all elements of rate of return regulation, including the calculation of shareable earnings. Beginning January 1, 2011, each URF Incumbent Local Exchange Carrier ("ILEC") is allowed full pricing flexibility for the basic residential rate. On December 31, 2010, the CPUC issued a ruling to initiate a new proceeding to assess whether, or to what extent, the level of competition in the telecommunications industry is sufficient to control prices for the four largest ILECs in the state, including SureWest Telephone, however this proceeding has been placed on hold. The CPUC's actions in this and future proceedings could lead to new rules and an increase in government regulation.

In December 2007, the CPUC issued a final decision in a proceeding investigating the continued need for an intrastate access element called the transport interconnection charge ("TIC"). The final decision capped SureWest Telephone's intrastate access charges through 2010 and the TIC was eliminated effective January 1, 2011. As a result of the lost TIC revenue, during the quarter and nine month period ended September 30, 2011 intrastate access revenues decreased \$489 and \$1,574, respectively.

## **10. COMMITMENTS AND CONTINGENCIES**

### **Litigation, Regulatory Proceedings and Other Contingencies**

We are subject to a variety of legal proceedings, regulatory proceedings, income tax exposures and claims that arise from time to time in the ordinary course of our business. Although management currently believes that resolving these matters, individually or in the aggregate, will not have a material adverse impact on our financial statements. However, these matters are subject to inherent uncertainties and management's view of these matters may change in the future. We believe that the most notable regulatory proceedings at the federal and state levels that could have a material impact on our operations are proceedings to alter the structure of intercarrier compensation and to implement universal service reform. It is not yet possible to determine fully the impact of the related FCC and state proceedings on our operations.

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

*(Amounts in thousands, except select operating metrics and share and per share amounts)*

Certain statements included in this report, including that which relates to the impact on future revenue sources and potential sharing obligations of pending and future regulatory orders, continued expansion of the telecommunications network and expected changes in the sources of our revenue and cost structure resulting from our entrance into new communications markets, are forward-looking statements and are made pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. These forward looking statements generally are identified by the words "believe", "expect", "anticipate", "estimate", "intend", "should", "may", "will", "would", "will be", "will continue" or similar expressions. Such forward looking statements involve known and unknown risks, the impact of current economic conditions, uncertainties and other factors that may cause actual results, performance or achievements of SureWest Communications (the "Company", "we" or "our") to be different from those expressed or implied in the forward-looking statements. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward—looking statements is included in our 2010 Annual Report on Form 10-K filed with the Securities and Exchange Commission ("SEC"). We disclaim any intention or obligation to update or revise publicly any forward-looking statements. Management's Discussion and Analysis ("MD&A") should be read in conjunction with our unaudited condensed consolidated financial statements and accompanying notes to the financial statements ("Notes") as of and for the nine months ended September 30, 2011 included in Item 1 of this Quarterly Report on Form 10-Q.

Throughout MD&A, we refer to measures that are not a measure of financial performance in accordance with United States generally accepted accounting principles ("US GAAP" or "GAAP"). We believe the use of these non-GAAP measures on a consolidated and segment basis provides the reader with additional information that is useful in understanding our operating results and trends. These measures should be viewed in addition to, rather than as a substitute for, those measures prepared in accordance with GAAP. See the Non-GAAP Measures section below for a more detailed discussion on the use and calculation of these measures.

#### **Overview**

We are one of the leading providers of integrated communications services and are the bandwidth leader in the markets we serve. We provide data, video and voice services to residential and business customers in the greater Sacramento, California ("Sacramento region") and greater Kansas City, Kansas and Missouri areas ("Kansas City area"). We continue to expand the use of optical fiber in our networks. We increasingly deploy our services by combining fiber-to-the-home ("FTTH") and fiber-to-the-node ("FTTN") facilities with the use of Internet Protocol ("IP") based communications protocol. Our advanced telecommunications networks give us a competitive edge that enables us to provide our customers with higher data speeds for Internet service and deploy multiple services at superior quality through our high bandwidth capacity. Our IP based communication protocol enables us to provide dedicated bandwidth at symmetrical data speeds to each of our customers in the Sacramento region. We classify our operations in two reportable segments: Broadband and Telecommunications ("Telecom").

#### *Broadband Segment*

Our Broadband segment generated approximately 76% of our consolidated operating revenues, primarily from subscriptions to our data, video and voice services ("broadband services") and business services during the nine-month period ended September 30, 2011. We market our broadband services to residential and business customers, either individually or as part of a bundled package. As of September 30, 2011, our broadband services served approximately 105,800 residential subscribers, of which 83% subscribed to two or more of our broadband services, including 46% that subscribed to all three of our broadband services ("triple play"). As of September 30, 2011, we had approximately 8,000 business customers. New products and features including Advanced Digital TV ("ADTV"), faster data speeds, increased high definition ("HD") channels, home networking and Internet security software created enhanced subscriber value for our broadband services. We continue to successfully offset industry-wide declines of operating revenues in the Telecom segment with our long-term strategy to grow our Broadband operations.

Our data service can provide high-speed Internet access at symmetrical speeds of up to 50 megabits per second ("Mbps"), depending on the nature of the network facilities that are available, the level of service selected and the geographic market availability. Our advanced telecommunications networks gives us the ability to offer our customers in many locations both faster and symmetrical data speeds, meaning Internet speeds downstream are the

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same as those upstream, than those of our competitors. Customers can use the faster speeds for such things as enhanced online gaming and faster uploading and downloading of multimedia content such as music, photos and video. As of September 30, 2011, approximately 63% and 29% of our data customers subscribed to speeds of 5 Mbps and 15 Mbps or greater, respectively. In the Sacramento region, approximately 40% of our data customers subscribe to plans with speeds at or higher than 15 Mbps. As of September 30, 2011, approximately 32% of the homes in the areas we serve subscribed to one of our high-speed Internet services.

Our video services range from a limited basic service to our newest product offering ADTV, powered by Microsoft® Mediaroom. Depending on the service selected and subject to geographic market availability, our video service subscribers have access to over 310 channels, including premium and pay-per-view channels (which include concerts, sporting events and movies); video on demand ("VOD") service (which allows access to a library of movies and the ability to start a selection at any time and to pause, rewind, fast-forward and replay); premium VOD channels, music channels and an interactive, on-screen program guide (which allows the subscriber to navigate the channel lineup, the VOD library and recorded programs). Digital video subscribers may also subscribe to our advanced services, which consist of high-definition television ("HDTV"), and/or digital video recorders ("DVR"). Our ADTV product, which is currently available in the Sacramento region only, includes a Whole Home DVR, which allows customers the ability to watch recorded shows on any television in the house, record multiple shows at one time and utilize an intuitive on-screen guide and user interface. We anticipate the deployment of a Whole Home DVR in the Kansas City area during the first half of 2012. As of September 30, 2011, approximately 23% of the homes in the areas we serve subscribed to one of our video services.

Our Voice over Internet Protocol ("VoIP") digital phone product ("VoIP phone service") is available in the Sacramento market, including those customers residing in the Telecom segment service territory. Customers can select individual services or bundled packages that may include unlimited local calling or unlimited local and domestic long distance calling plans. Our voice products also include value-added services such as voicemail, call waiting, caller identification and many other calling feature options. As of September 30, 2011, approximately 19% of the homes in our Sacramento market have subscribed to our VoIP phone service. We also offer traditional circuit-switched voice services in the areas we serve. Our Broadband segment's total voice penetration in the markets we serve was approximately 24% as of September 30, 2011.

We provide a variety of business communications services to small, medium and large business customers. The services we offer to our business customers include: fiber-optics-based high-speed Internet, customized data and Ethernet transport services, data center and disaster recovery solutions, traditional landline and VoIP phone services, wireless backhaul and digital TV. Utilizing our existing fiber-optic network, we have successfully secured contracts to serve approximately 390 wireless backhaul access points, primarily in the Sacramento region. We anticipate backhaul revenue will continue to grow as wireless carriers, faced with escalating consumer and business demand for mobile broadband connectivity, are forced to expand and improve their networks, and to replace existing backhaul facilities with new facilities capable of handling more traffic faster.

### *Telecom Segment*

Our Telecom segment, which operates only in the Sacramento region, offers a broad selection of telecommunications services including traditional circuit-switched voice services, long distance services and a number of lightly-regulated or non-regulated services. Most long distance services are offered by our subsidiary SureWest Long Distance, which is a reseller of long distance services.

The Telecom segment provides a variety of business service offerings to small, medium and large business customers, including many services over our advanced fiber network. The services we offer to our business customers include, but are not limited to customized data and Ethernet transport services, traditional landline and scalable IP communication systems. Although we have experienced declines in the Telecom segments business customer counts in recent years, we anticipate the Telecom segment's business customer count will stabilize and begin to trend favorably.

The Telecom segment also provides wholesale access services through the use of its network to the Broadband segment, which enables the Broadband segment to offer high-speed Internet, VoIP and video services to some customers within SureWest Telephone's service area. We anticipate the wholesale access services revenue stream will continue to increase as customers within the Telecom segment service territory continue to demand more broadband services.

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Telecom segment revenues have decreased as a percentage of our consolidated revenues over the past several years. During the nine months ended September 30, 2011, the Telecom segment generated 24% of our consolidated revenues, a decrease of 5% compared to the same period in 2010. The decline in revenues is primarily the result of an industry wide trend of declining circuit-switched voice Revenue-generating units ("RGUs") and a corresponding reduction in the use of related services. Many customers are choosing to subscribe to our Broadband Digital Phone product instead of the traditional circuit-switched phone service offered by SureWest Telephone. In addition, the Telecom segment revenues have been impacted by scheduled reductions in the subsidies we receive from governmental regulatory agencies. We expect the declines in Telecom revenues to flatten over the next two years, as the scheduled phase out of certain Telecom support mechanisms is completed and access line losses ease. The Telecom segment continues to generate the majority of our net income and adjusted free cash flow and remains an important part of our long-term growth strategy to fund the expansion of our Broadband segment.

### Results of Operations

The tables below reflect certain financial data (on a consolidated and segment basis) and select operating metrics for each of our reportable segments as of and for the quarters and nine-month periods ended September 30, 2011 and 2010.

#### Financial Data

	Quarter Ended September 30,				Nine Months Ended September 30,			
	2011	2010	\$ Change	% Change	2011	2010	\$ Change	% Change
<b>Operating revenues<sup>(1)</sup></b>								
Broadband	\$48,018	\$43,861	\$ 4,157	9 %	\$ 139,356	\$ 129,514	\$ 9,842	8 %
Telecom	14,979	17,256	(2,277)	(13)	45,158	52,339	(7,181)	(14)
Operating revenues	62,997	61,117	1,880	3	184,514	181,853	2,661	1
<b>Income (loss) from operations</b>								
Broadband	(1,583)	(2,942)	1,359	46	(7,677)	(12,436)	4,759	38
Telecom	5,554	7,959	(2,405)	(30)	17,932	22,632	(4,700)	(21)
Income from operations	3,971	5,017	(1,046)	(21)	10,255	10,196	59	1
<b>Net income (loss)</b>								
Broadband	(2,801)	(3,082)	281	9	(10,212)	(11,071)	859	8
Telecom	3,444	4,486	(1,042)	(23)	10,531	12,475	(1,944)	(16)
Net income	643	1,404	(761)	(54)	319	1,404	(1,085)	(77)
<b>Net cash provided by operating activities</b>	21,255	20,082	1,173	6	61,189	46,509	14,680	32
<b>Adjusted EBITDA<sup>(2)</sup></b>								
Broadband	11,621	10,008	1,613	16	33,351	26,616	6,735	25
Telecom	9,258	11,327	(2,069)	(18)	29,478	34,115	(4,637)	(14)
Adjusted EBITDA	20,879	21,335	(456)	(2)	62,829	60,731	2,098	3
<b>Free cash flow<sup>(2)</sup></b>								
Broadband	(6,904)	(1,843)	(5,061)	(275)	(14,809)	(6,040)	(8,769)	(145)
Telecom	4,709	6,115	(1,406)	(23)	13,840	15,205	(1,365)	(9)
Corporate	(10)	(45)	35	78	(1,551)	(984)	(567)	(58)
Free cash flow	(2,205)	4,227	(6,432)	(152)	(2,520)	8,181	(10,701)	(131)
<b>Adjusted free cash flow<sup>(2)</sup></b>								
Broadband	(404)	(1,667)	1,263	76	(804)	(5,776)	4,972	86
Telecom	5,664	6,268	(604)	(10)	15,725	16,226	(501)	(3)
Corporate	(10)	(45)	35	78	(1,551)	(984)	(567)	(58)
Adjusted free cash flow	5,250	4,556	694	15	13,370	9,466	3,904	41

(1) External customers only.

(2) A non-GAAP measure. See the Non-GAAP Measures section below for additional information and reconciliation to the most directly comparable GAAP measure.

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	<b>As of September 30,</b>			
	<b>2011</b>	<b>2010</b>	<b>Change</b>	<b>% Change</b>
<b>Broadband</b>				
Total residential subscribers <sup>(1)</sup>	105,800	104,000	1,800	2 %
Broadband residential revenue-generating units <sup>(2)</sup>	242,300	235,300	7,000	3
Data	101,300	99,200	2,100	2
Video	64,900	61,200	3,700	6
Voice	76,100	74,900	1,200	2
Total business customers <sup>(3)</sup>	8,000	7,700	300	4
<b>Telecom</b>				
Voice revenue-generating units <sup>(4)</sup>	24,200	30,700	(6,500)	(21)
Total business customers <sup>(3)</sup>	7,700	8,000	(300)	(4)

- (1) Total residential subscribers are customers who receive one or more residential data, video or voice services from one of our subsidiaries in the Broadband segment.
- (2) We can deliver multiple services to a customer. Accordingly, we maintain statistical data regarding RGUs for video, voice and data, in addition to the number of subscribers. For example, a single customer who purchases video, voice and data services would be reflected as three RGUs.
- (3) Total business customers are customers who receive business data, voice or video services and represent a distinct customer account.
- (4) Voice RGUs are residential customers who subscribe to one or more voice access lines.

**Consolidated Overview***Revenue and Cost Structure*

Our Broadband segment has grown significantly in recent years and now contributes the majority of our consolidated operating revenues and adjusted EBITDA. As we maintain our focus on growing the Broadband segment, the Telecom segment remains an important part of our long-term growth strategy and it continues to generate the majority of our net income and adjusted free cash flow. Our long-term strategy remains to continue growing our Broadband operations to counter the industry-wide trend of declines in Telecom revenues.

*Operating Revenues*

Operating revenues in the Broadband segment increased \$4,157 and \$9,842 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The increase in Broadband operating revenues was attributed to the continued growth in residential and business services. Broadband residential revenues increased \$2,705 and \$4,739 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 as a result of a 3% increase in RGUs and higher pricing for video and data services. The launch of our ADTV video product in the Sacramento market in 2010 also contributed to the growth in residential revenue and RGUs.

Broadband business revenues increased \$1,578 and \$5,368 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. Business customers increased 4% as of September 30, 2011 compared to the prior year as a result of growth, primarily in the Kansas City market. The variety of our product offerings and our ability to offer customized service packages to businesses of all sizes contributed to the current year growth in business revenue and will continue to provide us with new opportunities in the commercial market.

Utilizing our existing fiber-optic network, we are able to acquire and serve a more diversified business customer base and create new long-term revenue opportunities, such as wireless carrier backhaul and data center services. Wireless carrier backhaul revenue increased \$471 and \$1,730 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. Growth in these services is expected to continue to contribute to the increase in business revenue as the demand for wireless data continues to grow. We will continue to

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invest in new opportunities as they emerge in order to develop and enhance the broadband infrastructure and the residential and business services we offer, while focusing on the generation of new customers and increasing residential penetration on our existing marketable homes.

Operating revenues in the Telecom segment decreased \$2,277 and \$7,181 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. Residential services decreased \$890 and \$3,252 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 and was largely impacted by our customers' migration toward alternative communication services, including those offered by our Broadband segment. This migration contributed to a 21% decline in the Telecom segment voice RGUs as of September 30, 2011 compared to 2010. Business revenues decreased \$628 and \$758 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 as a result of a 4% decline in business customers. However, the decline was mitigated by higher pricing for data services, which was implemented during the third quarter of 2010. The decrease in operating revenues for the Telecom segment was also impacted by the scheduled reduction in support received from the California High Cost Fund ("CHCF") of \$510 and \$1,530 during the quarter and nine month period ended September 30, 2011, respectively, and the elimination of the transport interconnection charge ("TIC") as of January 1, 2011 which resulted in a decline in revenue of approximately \$489 and \$1,574 during the quarter and nine month period ended September 30, 2011, respectively. See the Regulatory Matters section below for a further discussion regarding the regulatory subsidies we receive.

The Telecom segment also provides wholesale access and other services to the Broadband segment, which enables the Broadband segment to offer high-speed Internet, VoIP, video and wireless backhaul services to some customers within SureWest Telephone's service area. These wholesale services are included as intersegment revenues and expenses in each of the respective segments and eliminated in the consolidated statements of operations.

### *Operating Expenses*

Consolidated operating expenses, excluding depreciation and amortization, increased \$2,796 and \$708 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010.

The increase in consolidated operating expenses was reduced in part by cost savings realized from the workforce reduction initiative implemented during the quarter ended June 30, 2010 in which approximately 60 positions were eliminated in order to improve operating efficiencies and align our operating costs with the decline in Telecom revenues. Affected employees were provided a range of benefits and resources, including severance. As a result, severance and other related termination costs of approximately \$1,428 were incurred during the nine-month period ended September 30, 2010. However, the decline in labor costs was offset by severance costs of \$1,100, which included share-based compensation expense of \$859, incurred as a result of the retirement of an executive officer during the nine-month period ended September 30, 2011.

Cost of services and products expense increased \$1,894 and \$2,581 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. Programming and network costs related to providing video and data services continue to increase as a result of an increase in programming fees per subscriber and the growth in residential and business services. However, the nine-month period ended September 30, 2011 was also largely affected by a reduction in Universal Service Administrative Company ("USAC") expense resulting from the recovery of universal service fund ("USF") fees of \$1,427 related to 2010 and the quarter ended March 31, 2011. See the Other Adjustments section below for a further discussion regarding this matter.

Customer operations and selling expense increased \$743 during the quarter and decreased \$396 during the nine-month period ended September 30, 2011 compared to the same periods in 2010. Sales and advertising costs increased as a result of a new advertising campaign implemented during the quarter ended September 30, 2011. However, labor costs, primarily for customer services, declined during the nine-month period ended September 30, 2011 resulting from a reduction in headcount through the workforce reduction initiative implemented in 2010.

General and administrative expenses increased \$159 during the quarter and decreased \$1,477 during the nine-month period ended September 30, 2011 compared to the same periods in 2010 primarily as a result of employee severance costs of \$934 incurred during the nine months ended September 30, 2010 related to the workforce reduction initiative and savings in labor costs as a result of the reduction in headcount. Other administrative expenses also declined as a result of continued cost reduction initiatives. However, these cost savings were offset in part by the severance costs of \$1,100 for a retiring officer during the nine-month period ended September 30, 2011.

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Our consolidated depreciation and amortization expense increased \$130 and \$1,894 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 primarily due to the continued expansion of the network and success-based capital projects undertaken within the residential and business broadband service territories.

### *Income from Operations and Adjusted EBITDA*

Income from operations decreased \$1,046 during the quarter and increased \$59 during the nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. As described above, income from operations decreased primarily as a result of an increase in programming and network costs as well as additional advertising and promotional expenses related to a new advertising campaign during the current quarter. Adjusted EBITDA decreased \$456 during the quarter and increased \$2,098 during the nine-month period ended September 30, 2011 compared to the same periods in 2010. We continued to maintain positive adjusted EBITDA growth during the nine-month period ended September 30, 2011 by successfully replacing the declines in the Telecom segment with growth in our Broadband segment and through cost savings as a result of the workforce reduction initiative implemented during the second quarter of 2010.

### *Free Cash Flow and Adjusted Free Cash Flow*

Free cash flow decreased \$6,432 and \$10,701 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The decrease was largely due to additional capital expenditures related to the expansion of our fiber network during the quarter and nine-month period ended September 30, 2011. In 2011, we have planned additional capital investments for network expansion which will include the addition of 15,500 fiber marketable homes in the Kansas City area and the upgrade of 6,800 copper homes within the telephone service area of the Incumbent Local Exchange Carrier ("ILEC") so that they will be video service capable. As of September 30, 2011, we added 9,600 of the planned fiber marketable homes in the Kansas City area and upgraded 5,800 of the planned homes in the ILEC territory. Adjusted free cash flow, which excludes the capital expenditures for network expansion, increased \$694 and \$3,904 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. We expect capital expenditures and associated free cash flow to vary quarter to quarter based on the expansion of our fiber network in Kansas City and the resulting opportunities for additional residential and business services growth.

### *Other Adjustments*

Our subsidiaries provide services to customers for which they are required to contribute to the universal service fund. Each subsidiary collects USF fees from its customers and we remit these amounts to the USAC, the administrator of the Federal USF. SureWest Telephone provides wholesale transport services to SureWest Broadband, which SureWest Broadband resells to its own customers. The SureWest Broadband voice services are subject to USF fees. During the quarter ended June 30, 2011, we determined that SureWest Telephone remitted USF fees to USAC relating to the wholesale transport for voice services which it sells to SureWest Broadband for the year ended December 31, 2010 and the quarters ended March 31, 2011 and June 30, 2011. We also determined that SureWest Broadband had remitted USF fees to USAC relating to the voice services provided to its customers during the same time periods, including those services utilizing SureWest Telephone wholesale transport. Wholesale transport services provided by SureWest Telephone to SureWest Broadband for the resale as voice services are not subject to USF fees for SureWest Telephone, generally because USF contributions are being collected from the end user customers of SureWest Broadband who use these resold wholesale services. Accordingly, in June 2011, SureWest Telephone filed an amended remittance form with USAC to recover \$906 of the fees paid for the year ended December 31, 2010. During the quarter ended September 30, 2011, USAC approved our amended filing and the USF fees are being refunded to SureWest Telephone monthly through the first quarter of 2012. The USF fees of \$303 and \$329 for the quarters ended March 31, 2011 and June 30, 2011, respectively, will be refunded to SureWest Telephone based on its annual remittance form to be filed with USAC during the first quarter of 2012. In addition, SureWest Broadband recorded a \$218 reduction to its USAC expense during the quarter ended June 30, 2011 relating to revised estimates to its interstate traffic that will be included in its annual remittance form to be filed with USAC in the first quarter of 2012. We expect to receive the refunds from the annual remittance filings during the third quarter of 2012. For the fees relating to 2010 and the quarter ended March 31, 2011, we recognized a reduction in operating expense

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(within costs of services and products) on the condensed consolidated statements of income of \$1,427 for the nine-month period ended September 30, 2011. This resulted in an increase to consolidated net income by \$856 (\$0.06 per share) for the nine months ended September 30, 2011 and a corresponding receivable of \$1,756 on the condensed consolidated balance sheets. We received repayment of \$307 from USAC during the third quarter of 2011 for the fees related to 2010 and expect to receive the remaining short-term receivable balance of \$1,449 by the end of the third quarter of 2012.

## Segment Results of Operations

### Broadband

	Quarter Ended September 30,				Nine Months Ended September 30,			
	2011	2010	\$ Change	% Change	2011	2010	\$ Change	% Change
Data	\$ 13,672	\$ 12,100	\$ 1,572	13 %	\$ 38,824	\$ 36,493	\$ 2,331	6 %
Video	13,336	12,151	1,185	10	38,992	36,536	2,456	7
Voice	6,652	6,704	(52)	(1)	19,763	19,811	(48)	(0)
Total residential revenues	33,660	30,955	2,705	9	97,579	92,840	4,739	5
Business	13,557	11,979	1,578	13	39,170	33,802	5,368	16
Access	509	481	28	6	1,569	1,749	(180)	(10)
Other	292	446	(154)	(35)	1,038	1,123	(85)	(8)
Total operating revenues from external customers	48,018	43,861	4,157	9	139,356	129,514	9,842	8
Intersegment revenues	152	110	42	38	467	423	44	10
Operating expenses								
Cost of services and products <sup>(1)</sup>	27,407	25,719	1,688	7	79,741	75,008	4,733	6
Customer operations and selling	5,624	4,940	684	14	15,995	16,886	(891)	(5)
General and administrative	4,148	3,645	503	14	13,404	13,550	(146)	(1)
Depreciation and amortization	12,574	12,609	(35)	(0)	38,360	36,929	1,431	4
Loss from operations	(1,583)	(2,942)	1,359	46	(7,677)	(12,436)	4,759	38
Net loss	(2,801)	(3,082)	281	9	(10,212)	(11,071)	859	8
Adjusted EBITDA <sup>(2)</sup>	11,621	10,008	1,613	16	33,351	26,616	6,735	25

<sup>(1)</sup> Exclusive of depreciation and amortization.

<sup>(2)</sup> A non-GAAP measure. See the Non-GAAP Measures section below for additional information and reconciliation to the most directly comparable GAAP measure.

### Broadband Segment Overview

Adjusted EBITDA and loss from operations for the Broadband segment continued to improve during the quarter and nine-month period ended September 30, 2011 compared to the same periods in 2010 and is reflective of our long-term strategy to invest in and grow the Broadband business. The investment in our network over the last several years has created a technologically-advanced service platform, which enables us to grow revenues through increased penetration of a broad range of network facilities and services, as well as to create new long-term revenue opportunities with only nominal capital expenditures. We continue to successfully migrate Telecom customers to our Broadband VoIP phone service product mitigating the loss of Telecom voice RGUs. The successful launch during 2010 of our ADTV product in the Sacramento market and switched digital video and DOCSIS 3.0 in our Kansas City market has enabled us to capture customers who seek the high data speeds and enhanced products our network can provide. As a result, data and video revenues continued to increase for both residential and business services. Growth in business revenues significantly contributed to the increase in adjusted EBITDA during the quarter and nine-month period ended September 30, 2011 compared to the same periods in 2010 as a result of an increase in wireless carrier backhaul and a 4% increase in business customers. We anticipate continued growth in wireless carrier backhaul services as consumer demand for managed services and wireless data continues to increase.

In addition, during the nine-months ended September 30, 2010, we implemented a strategic restructuring designed to improve operating efficiencies and enhance our focus on the growth of the Broadband segment. This cost cutting initiative resulted in cost savings as a result of a reduction in the workforce and reduced professional fees.

## Broadband Segment Operating Revenues

### Residential Revenues

Broadband residential revenues increased \$2,705 and \$4,739 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The increase in residential revenues was due in part to the 3% growth in Broadband residential RGUs as of September 30, 2011 compared to 2010. Broadband residential revenues also increased as a result of higher pricing for video and data services implemented in September 2010 and July 2011. We are realizing the benefits of the investment we made in our network over the last several years. Our fiber network in the Sacramento region enables us to cost effectively provide customers with faster data speeds, offer new services and upgrade existing services as we continue to enhance the value of our broadband services for our customers. The launch of DOCSIS 3.0 in our Kansas City market in 2010 significantly enhanced our hybrid fiber coaxial ("HFC") network, which enables us to offer our customers faster data speeds and additional HD channels. The success of our ADTV product in our Sacramento market has resulted in higher take rates for our triple-play services as a bundled package. We anticipate continued growth in residential broadband RGUs resulting from our VoIP phone service, our ADTV product and an increase in residential fiber marketable homes in 2011 through the expansion of our network in our Kansas City market and through the enhancement of our copper network in the Sacramento market.

#### *Data*

We offer high speed Internet access at symmetrical speeds of up to 50 Mbps, depending on the nature of the network facilities that are available, the level of service selected and the location. The reliability and high speeds of the data service in both the Sacramento and Kansas City markets enhance other services such as VoIP and Digital Phone, where customers manage phone services through the online SureWest portal. Through the SureWest portal, customers can manage their VoIP or Digital Phone service and access a variety of value added features and enhancements that are designed to take advantage of the speed of the Internet service we provide.

Our residential data revenues increased \$1,572 and \$2,331 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 primarily as a result of a 2% increase in data RGUs and a 11% increase in average monthly revenue per user ("ARPU") as a result of higher price points on our data services, as discussed above.

#### *Video*

Our video services range from limited basic service to our newest product offering ADTV, which launched in January 2010. ADTV is currently deployed through our copper and fiber networks in the greater Sacramento region. The integration of the new Mediaroom platform includes a Whole Home DVR, which allows customers the ability to watch recorded shows on any television in the house, record multiple shows at one time and utilize an intuitive on-screen guide and user interface. During 2011, we successfully upgraded our Mediaroom platform to enhance many of our existing features and to provide future product enhancements. In addition to the ability to watch recorded shows on any television in the house, customers can now pause, rewind and fast-forward live programs on all televisions in the home. In September 2011, we upgraded our Kansas City VOD service with VODlink 5.0 software application. The "Watch and Buy" technology of this application allows our customers to purchase, for home delivery, DVD and Blu-ray versions of movie titles the same day they are released for VOD viewing. In addition, the new software application provides faster VOD navigation and enhanced graphics. Our services are delivered utilizing FTTH and FTTN networks, which allows us to offer a high quality experience with digital TV packages. Our full digital video package provides access to approximately 352 and 337 channels in our California and Kansas City markets, respectively, including premium and pay-per-view channels, VOD service, premium VOD channels, music channels and an interactive, on-screen program guide. Digital video subscribers can also subscribe to additional services, including a DVR and HDTV. As of September 30, 2011, our customers had access to 83 and 78 HD channels in our California and Kansas City markets, respectively.

Residential video revenues increased \$1,185 and \$2,456 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. Revenues increased as a result of a 6% increase in video RGUs and higher pricing on many of our video service offerings, as discussed above. We continue to enhance the subscriber value for our broadband services by offering new products and features including ADTV, a Whole Home DVR, faster data speeds and additional channels including premium, VOD and HD channels. In addition,

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during 2011, we are enhancing our copper network in the Sacramento region and expanding our fiber network in the Kansas City market. The network enhancement in the Sacramento region will allow us to upgrade an additional 6,800 copper homes within the ILEC service territory to be video service capable and offer access to our ADTV service. As of September 30, 2011, we have completed upgrades to 5,800 homes on the copper network and passed 9,600 marketable homes in the Kansas City area of the additional 15,500 fiber homes planned for 2011.

### *Voice*

We offer phone services that provide local and long-distance calling and include features such as caller ID and call waiting. Our VoIP phone service is offered in the Sacramento market and is available in packages ranging from basic telephone service to unlimited local and domestic long distance calling plans. Nearly all of our VoIP phone service plans include enhanced calling features such as caller ID on TV, Find Me/Follow Me, sequential ringing and selective call acceptance and rejection. Voice RGUs in the Sacramento market increased 5% as of September 30, 2011 compared to the same period in 2010. As of September 30, 2011, approximately 19% of the homes in our Sacramento market have subscribed to our VoIP phone service. Our VoIP phone service in the Sacramento market offers our customers, including those in the Telecom service territory, an alternative to traditional circuit switched land line service and presents our customers with a more competitive triple-play offering with increased options and multiple packages.

Residential voice revenues decreased \$52 and \$48 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. Although voice RGUs increased 2% as of September 30, 2011 compared to the same period in 2010, the change in voice revenues was offset by a decline in ARPU as a result of promotional discounts during the quarter and nine-month period ended September 30, 2011.

### **Business Revenues**

We provide a variety of business communications services to small, medium and large business customers. The services we offer to our business customers include: fiber-optics-based high-speed Internet, customized data and Ethernet transport services, data center and disaster recovery solutions, traditional landline and VoIP phone services, wireless backhaul and digital TV.

Business revenues increased \$1,578 and \$5,368 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 due primarily to a 4% increase in business customers during the same periods. ARPU also increased 8% as of September 30, 2011 compared to the same period in 2010, primarily due to increases in wireless backhaul services.

Wireless backhaul revenue increased \$471 and \$1,730 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. We anticipate backhaul revenue will continue to grow as wireless carriers, faced with escalating consumer and business demand for mobile broadband connectivity, are forced to expand and improve their networks, and to replace existing backhaul facilities with new facilities capable of handling more traffic at faster rates. Our existing fiber-optic network provides the capacity to secure new wireless carrier backhaul agreements and create new long-term revenue opportunities without significant additional capital expenditures.

### **Access Revenues**

Access revenues increased \$28 during the quarter and decreased \$180 during the nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The decrease was mostly attributable to cash settlements received during the nine months ended September 30, 2010 from certain telecommunications carriers relating to disputed carrier access charges.

### **Broadband Segment Operating Expenses**

Total operating expenses in the Broadband segment, excluding depreciation and amortization, increased \$2,875 and \$3,696 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010.

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Cost of services and products (exclusive of depreciation and amortization) increased \$1,688 and \$4,733 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The increase in costs in the current year was largely due to direct costs incurred to provide our voice, video and data services. Video programming fees are paid to programming networks to license the programming we distribute to our video customers. Video programming costs continue to increase due to the growth in residential video RGUs, the expansion of channels offered and an increase in costs on a per subscriber basis and per program channel, particularly for sports and HD channels.

We also incur network access and transport costs to provide data and voice services to our customers. Transport costs increased as a result of growth in our business customer base. In addition, due to the rising demand for our VoIP product in the Sacramento market and the additional capacity required to handle the increasing volume of data usage, network access costs have increased in the current year periods. Network access costs include costs paid to external vendors as well as our Telecom segment, in accordance with the provisions of a wholesale access agreement. The wholesale access agreement enables the Broadband segment to offer high-speed Internet, VoIP, video and wireless backhaul services to its customers within the Telecom segment territory.

Customer operations expense increased \$684 and decreased \$891 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. Sales and advertising costs increased in the current year as a result of a new advertising campaign implemented during the quarter ended September 30, 2011, which included radio and television advertising and promotional materials. The increase in costs to support the new advertising campaign was offset by a decrease in labor costs during the nine-months ended September 30, 2011 primarily due to a reduction in headcount through the workforce reduction initiative implemented during 2010.

General and administrative expense increased \$503 during the quarter and decreased \$146 during the nine-month period ended September 30, 2011 compared to the same periods in 2010. The increase for the current quarter was due primarily to an increase in stock based compensation expense. The decrease in costs during the nine-months ended September 30, 2011 was primarily due to (i) a decline in labor costs resulting from a reduction in headcount, (ii) a decrease in professional fees, (iii) a reduction in information technology costs related to system maintenance and development and (iv) severance costs of approximately \$451 incurred during the nine months ended September 30, 2010 related to the workforce reduction initiative. However, these cost savings were offset in part by severance costs including share-based compensation expense incurred during the nine months ended September 30, 2011 for a retiring officer.

Depreciation and amortization expense decreased \$35 during the quarter and increased \$1,431 during the nine-month period ended September 30, 2011, compared to the same periods in 2010. Depreciation and amortization expense continues to increase due primarily to the continued expansion and enhancement of the broadband network and success-based capital projects. During the quarter ended September 30, 2011, the increase in depreciation expense was reduced by a gain on the sale of retired equipment.

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### **Telecom**

	<b>Quarter Ended September 30,</b>				<b>Nine Months Ended September 30,</b>			
	<b>2011</b>	<b>2010</b>	<b>\$ Change</b>	<b>% Change</b>	<b>2011</b>	<b>2010</b>	<b>\$ Change</b>	<b>% Change</b>
Residential	\$ 3,196	\$ 4,086	\$ (890)	(22) %	\$ 10,181	\$ 13,433	\$ (3,252)	(24) %
Business	8,122	8,750	(628)	(7)	24,810	25,568	(758)	(3)
Access	3,559	4,274	(715)	(17)	9,761	12,842	(3,081)	(24)
Other	102	146	(44)	(30)	406	496	(90)	(18)
Total operating revenues from external customers	14,979	17,256	(2,277)	(13)	45,158	52,339	(7,181)	(14)
Intersegment revenues	5,231	5,275	(44)	(1)	15,579	15,285	294	2
Operating expenses								
Cost of services and products <sup>(1)</sup>	5,898	5,677	221	4	15,716	17,407	(1,691)	(10)
Customer operations and selling	2,667	2,621	46	2	7,716	7,320	396	5
General and administrative	2,855	3,203	(348)	(11)	9,791	11,146	(1,355)	(12)
Depreciation and amortization	3,236	3,071	165	5	9,582	9,119	463	5
Income from operations	5,554	7,959	(2,405)	(30)	17,932	22,632	(4,700)	(21)
Net income	3,444	4,486	(1,042)	(23)	10,531	12,475	(1,944)	(16)
Adjusted EBITDA <sup>(2)</sup>	9,258	11,327	(2,069)	(18)	29,478	34,115	(4,637)	(14)

<sup>(1)</sup> Exclusive of depreciation and amortization.

<sup>(2)</sup> A non-GAAP measure. See the Non-GAAP Measures section below for additional information and reconciliation to the most directly comparable GAAP measure.

### **Telecom Segment Overview**

Telecom revenues continue to experience an overall decline resulting from an industry-wide trend of access line attrition and scheduled reductions in the subsidies we receive from governmental regulatory agencies. Access revenues will continue to decline through 2011 due to scheduled reductions in the CHCF subsidy and the elimination of transport interconnection revenue, which was effective January 1, 2011. However, we anticipate Telecom revenue declines to slow over the next several years as the scheduled phased reductions of our subsidies are completed and access line losses level off. Revenues earned by the Telecom segment through a wholesale access agreement with the Broadband segment increased during the quarter and nine-month period ended September 30, 2011 compared to the same periods in 2010. We anticipate the wholesale revenue stream to continue to trend favorably as consumers within the Telecom segment service territory continue to demand more broadband services. As technology and the regulatory environment changes within the communications industry, the Telecom segment will increasingly consist of services that generate higher margins such as business and wholesale services. Business and wholesale services comprised 67% of total Telecom revenues at September 30, 2011 compared to 60% during the same period in 2010. The Telecom segment continues to contribute the majority of our net income and adjusted free cash flow.

### **Telecom Segment Operating Revenues**

#### **Residential Revenues**

SureWest Telephone offers several different phone service options, from basic local service packages to unlimited California and nationwide flat-rate plans. All of the plans include options for voicemail and other calling features such as caller ID and call forwarding. SureWest Telephone residential revenues decreased \$890 and \$3,252 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 as we continue to be impacted by the industry-wide decline in residential access lines and competition from wireless, wireline, and digital phone competitors (including SureWest Broadband). Residential voice RGUs declined 21% as of September 30, 2011 compared to the same period in 2010. We continue to mitigate additional voice access line and operating revenue losses through our VoIP phone service offered to customers within the Telecom service area through our Broadband segment. As a result, we expect a portion of the Telecom segment's voice revenue will continue to shift to the VoIP service being offered by our Broadband segment. As of September 30, 2011, 40% of the decline in Telecom voice RGUs in 2011 was due to customers who have transferred to SureWest Broadband's VoIP

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phone service rather than moving to competitors. See the Broadband segment residential revenue section above for a more detailed discussion regarding VoIP and other services offered by SureWest Broadband.

### **Business Revenues**

We provide a variety of business service offerings to small, medium and large business customers, including many services over our advanced fiber network. The services we offer to our business customers include, but are not limited to customized data and Ethernet transport services, traditional landline and scalable IP communication systems.

SureWest Telephone business revenues decreased \$628 and \$758 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The decrease in revenue was primarily due to a 4% decline in business customers which resulted from the strained economic conditions for small and medium sized businesses and continued strong competitive pressures, as discussed above. The decrease in business revenue was mitigated in part by a price increase for data services implemented during the third quarter of 2010.

### **Access Revenues**

Access revenues, which include interstate and intrastate switched access revenue, interstate common line ("CL") revenue and support payments from the CHCF, decreased \$715 and \$3,081 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. As anticipated, scheduled reductions in subsidies received from the CHCF resulted in support received during the quarter and nine-month period ended September 30, 2011 to decrease \$510 and \$1,530, respectively, compared to the same periods in 2010. Switched access revenue also decreased \$513 and \$1,919 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010, primarily due to the elimination of the TIC, effective January 1, 2011. See the Regulatory Matters section below for a more detailed discussion regarding SureWest Telephone's regulated revenues.

### **Intersegment Revenues**

Intersegment revenues consist predominately of revenues earned through a wholesale access agreement between the Telecom and Broadband segments. The Telecom segment supplies wholesale access services through its network to the Broadband segment, which enables the Broadband segment to offer high-speed Internet, VoIP, video and wireless backhaul services to customers residing within the Telecom service territory. Wholesale access and Digital Subscriber Line ("DSL") intersegment revenue increased \$230 and \$954 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010 and is anticipated to continue to increase with heightened demand for the Broadband segment's VoIP and ADTV products offered in the Telecom segment service territory. See the Broadband operating revenue section above for more detailed discussion of the Broadband revenues and product offerings.

### **Telecom Segment Operating Expenses**

Total operating expenses for the Telecom segment, excluding depreciation and amortization, decreased \$81 and \$2,650 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010.

Cost of services and products (exclusive of depreciation and amortization) increased \$221 during the quarter and decreased \$1,691 during the nine-month period ended September 30, 2011 compared to the same periods in 2010. USAC expense decreased as a result of the recovery during the nine months ended September 30, 2011 of USF fees of \$1,209 related to 2010 and the quarter ended March 31, 2011. See the Other Adjustments section in Consolidated Overview above for additional information regarding this matter. In addition, costs to support local and long distance services decreased as a result of the decline in residential voice RGUs and business customers.

Customer operations expense increased \$46 and \$396 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The increase in the current year periods was mostly attributable to an increase in advertising and promotions related to a new residential advertising campaign during the current quarter.

General and administrative expense decreased \$348 and \$1,355 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The decrease in costs in the current year periods was primarily due to (i) employee severance costs of \$483 incurred during the nine months ended September

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30, 2010 and (ii) a decline in labor and other administrative costs resulting from a reduction in headcount and cost reduction initiatives implemented in 2010. However, these cost savings were offset in part by severance costs including share-based compensation expense incurred for a retiring officer during the nine-month period ended September 30, 2011.

Depreciation and amortization expense increased \$165 and \$463 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The increase is primarily from upgrades to the copper network and digital VoIP equipment installations for customers within the ILEC territory.

### **Regulatory Matters**

Revenues subject to broad Federal or state regulation, which include such telecommunications services as local telephone service, network access service and toll service, are derived from various sources, including:

- business and residential subscribers of basic exchange services;
- surcharges mandated by state commissions;
- long distance carriers, for network access service;
- competitive access providers and commercial enterprises for network access service;
- interstate pool settlements from NECA;
- support payments from federal or state programs; and
- support payments from the CHCF, recovering costs of services including extended area service.

Certain of our interstate telecommunications service rates are subject to regulation by the Federal Communications Commission ("FCC"). Interstate switched and special access rates are established through a SureWest Telephone tariff filed with the FCC. For interstate CL charges, SureWest Telephone concurs with tariffs filed by National Exchange Carrier Association ("NECA"). Intrastate service rates are subject to regulation by state commissions. Prices for intrastate telecommunications services are established through tariffs or through other regulatory mechanisms, including, in California, service guides. Pending and future regulatory actions may have a material impact on our consolidated financial position and results of operations.

#### *FCC Matters*

Under current FCC rules governing rate making, SureWest Telephone is required to establish rates for its interstate telecommunications services based on projected demand usage for the various services. SureWest Telephone projects its earnings through the use of annual cost separation studies, which utilize estimated total cost information and projected demand usage. Carriers are required to follow FCC rules in the preparation of these annual studies. SureWest Telephone determines actual earnings from its interstate rates as actual volumes and costs become known. The FCC monitors SureWest Telephone's interstate earnings.

In an April 6, 2010 decision, a Federal appeals court found that the FCC lacked authority over certain Internet-related practices of Comcast. This decision came during a proceeding that had been initiated by the FCC to adopt rules related to the conduct of providers of retail Internet services. Notwithstanding the Federal appeals court decision, on December 21, 2010, the FCC adopted rules requiring that such providers honor certain operating principles, including principles of (i) transparency, (ii) no blocking, (iii) no unreasonable discrimination and (iv) reasonable network management in connection with their Internet services. We are in the process of implementing the rules, which are effective November 20, 2011, however challenges to the rules have been filed with the U.S. Court of Appeals.

In addition, the FCC initiated action on February 8, 2011 to again consider reform of the current structure for intercarrier compensation and to consider rules for transitioning the current universal service fund to support broadband deployment. New rounds of comments were filed in April and May 2011, with ongoing follow-up advocacy filings and meetings. The FCC is expected to take action on these matters during the fourth quarter of 2011. The FCC's actions in these and future proceedings could significantly alter the structure of these arrangements, and affect the costs and sources or revenue for affected service providers. Action in any of these proceedings could have a material impact on us. We will continue to monitor these matters, participate in them as we deem appropriate, and assess the potential impact on our consolidated financial position and results of operations.

#### *California Public Utility Commission ("CPUC") Matters*

A CPUC decision in August 2005 allowed SureWest Telephone to continue receiving our \$11,500 annual draw from the CHCF on an interim basis pending further CPUC action. The CHCF was previously authorized by the CPUC to offset SureWest Telephone's intrastate regulated operating expenses on an interim basis. In August 2006, we

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requested permission from the CPUC to implement a graduated phase-down of our annual \$11,500 interim draw. In September 2007, the CPUC issued Decision 07-09-002 which provides for SureWest Telephone to phase-down its interim annual CHCF draw over a five-year period. The phase-down of the interim draw began in January 2007, initially reducing the annual \$11,500 interim draw to \$10,200, and in each subsequent year will be incrementally reduced by \$2,040. In 2010 our interim CHCF draw was \$4,080, and for 2011 our interim CHCF draw is \$2,040.

In an ongoing proceeding relating to the New Regulatory Framework (under which SureWest Telephone has been regulated since 1996), the CPUC adopted Decision 06-08-030 in 2006, which grants carriers broader pricing freedom in the provision of telecommunications services, bundling of services, promotions and customer contracts. This decision adopted a new regulatory framework, the Uniform Regulatory Framework ("URF"), which among other things (i) eliminates price regulation and allows full pricing flexibility for all new and retail services except basic residential services, which limits increases to \$3.25 per year during 2009 and 2010, (ii) allows new forms of bundles and promotional packages of telecommunication services, (iii) allocates all gains and losses from the sale of assets to shareholders and (iv) eliminates almost all elements of rate of return regulation, including the calculation of shareable earnings. Beginning January 1, 2011, each URF ILEC is allowed full pricing flexibility for the basic residential rate. On December 31, 2010, the CPUC issued a ruling to initiate a new proceeding to assess whether, or to what extent, the level of competition in the telecommunications industry is sufficient to control prices for the four largest ILECs in the state, including SureWest Telephone, however this proceeding has been placed on hold. The CPUC's actions in this and future proceedings could lead to new rules and an increase in government regulation.

In December 2007, the CPUC issued a final decision in a proceeding investigating the continued need for an intrastate access element called the TIC. The final decision capped SureWest Telephone's intrastate access charges through 2010 and the TIC was eliminated effective January 1, 2011. The reduction in our 2011 intrastate access revenues will be approximately \$2,050.

### *Other Regulatory Matters*

We are also subject to a number of regulatory proceedings occurring at the federal and state levels that may have a material impact on our operations. The FCC and state commissions have authority to issue rules and regulations related to our business. A number of proceedings are pending or anticipated that are related to such telecommunications issues as competition, interconnection, access charges, intercarrier compensation, broadband deployment, consumer protection and universal service reform. Some proceedings may authorize new services to compete with our existing services. Proceedings that relate to our cable television operations include rulemakings on set top boxes, carriage of programming, industry consolidation and ways to promote additional competition. There are various on-going legal challenges to the scope or validity of FCC orders that have been issued. As a result, it is not yet possible to determine fully the impact of the related FCC rules and regulations on our operations.

## **Non-Operating Items**

### *Other Income and Expense, Net*

Consolidated interest expense increased \$186 and \$3,323 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. In March 2011, we entered into a Credit Agreement to refinance our existing long-term debt, as described in the Liquidity and Capital Resources section below. As a result of entering into the Credit Agreement, we recognized debt issuance costs of \$301 and incurred early termination fees of \$2,346 related to the repayment of our Series A and Series B Senior Notes during the nine-month period ended September 30, 2011.

We received patronage dividends of \$902 and \$979 during the quarters ended March 31, 2011 and 2010, respectively. We earn patronage dividends from CoBank, ACB ("CoBank") based on our share of the net income earned by CoBank. We record the receipt of the patronage dividends against interest expense.

### *Income Taxes*

Income taxes decreased \$1,039 and \$2,131 during the quarter and nine-month period ended September 30, 2011, respectively, compared to the same periods in 2010. The decreases were due primarily to a decrease in pre-tax book income and a reduction in our effective income tax rate. The effective federal and state income tax rates were 39.8% and 62.5% for the nine-month periods ended September 30, 2011 and 2010, respectively. The decrease in the effective tax rate in the current year compared to the prior year was due primarily to a favorable tax treatment of

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dividends both paid and received and the release of unrecognized tax benefits offset by a change to state deferred tax expense attributable to apportionment changes.

### Non-GAAP Measures

In addition to the results reported in accordance with US GAAP, we also use certain non-GAAP measures including adjusted EBITDA, free cash flow and adjusted free cash flow to evaluate operating performance and to facilitate the comparison of our historical results and trends. These non-GAAP measures are also used to manage and evaluate the operating performance of our reportable segments. These financial measures are not a measure of financial performance under US GAAP and should not be considered in isolation or as a substitute for net income (loss) as a measure of performance and net cash provided by operating activities as a measure of liquidity. The calculation of these non-GAAP measures may not be comparable to similarly titled measures used by other companies. Reconciliations to the most directly comparable GAAP measure are provided below.

#### *Adjusted EBITDA*

Adjusted EBITDA represents net income (loss) excluding amounts for income taxes; depreciation and amortization; non-cash pension and certain post-retirement benefits; non-cash stock compensation; severance and other related termination costs; and all other non-operating income and expenses. Adjusted EBITDA is a common measure of operating performance in the telecommunications industry. Adjusted EBITDA helps us evaluate our performance by removing from our operating results non-cash items and items which do not relate to our core operating performance.

The following tables are a reconciliation of net income (loss) to adjusted EBITDA for the quarters and nine-month periods ended September 30, 2011 and 2010:

	<b>Quarter Ended September 30, 2011</b>		
	<b>Broadband</b>	<b>Telecom</b>	<b>Consolidated</b>
Net income (loss)	\$ (2,801)	\$ 3,444	\$ 643
Add (subtract):			
Income tax expense (benefit)	(1,867)	2,156	289
Other (income) expense	3,085	(46)	3,039
Depreciation and amortization	12,574	3,236	15,810
Non-cash pension and post-retirement expense	173	178	351
Non-cash stock compensation expense	457	290	747
Adjusted EBITDA	<u>\$ 11,621</u>	<u>\$ 9,258</u>	<u>\$ 20,879</u>

  

	<b>Nine Months Ended September 30, 2011</b>		
	<b>Broadband</b>	<b>Telecom</b>	<b>Consolidated</b>
Net income (loss)	\$ (10,212)	\$ 10,531	\$ 319
Add (subtract):			
Income tax expense (benefit)	(6,793)	7,004	211
Other (income) expense	9,328	397	9,725
Depreciation and amortization	38,360	9,582	47,942
Non-cash pension and post-retirement expense	513	545	1,058
Non-cash stock compensation expense	2,155	1,419	3,574
Adjusted EBITDA	<u>\$ 33,351</u>	<u>\$ 29,478</u>	<u>\$ 62,829</u>

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	<b>Quarter Ended September 30, 2010</b>		
	<b>Broadband</b>	<b>Telecom</b>	<b>Consolidated</b>
Net income (loss)	\$ (3,082)	\$ 4,486	\$ 1,404
Add (subtract):			
Income tax expense (benefit)	(2,066)	3,394	1,328
Other (income) expense	2,206	79	2,285
Depreciation and amortization	12,609	3,071	15,680
Non-cash pension and post-retirement expense	181	190	371
Non-cash stock compensation expense	160	107	267
Adjusted EBITDA	<u>\$ 10,008</u>	<u>\$ 11,327</u>	<u>\$ 21,335</u>

	<b>Nine Months Ended September 30, 2010</b>		
	<b>Broadband</b>	<b>Telecom</b>	<b>Consolidated</b>
Net income (loss)	\$ (11,071)	\$ 12,475	\$ 1,404
Add (subtract):			
Income tax expense (benefit)	(7,437)	9,779	2,342
Other (income) expense	6,072	378	6,450
Depreciation and amortization	36,929	9,119	46,048
Non-cash pension and post-retirement expense	548	584	1,132
Non-cash stock compensation expense	1,106	1,105	2,211
Severance and other related termination costs <sup>(1)</sup>	469	675	1,144
Adjusted EBITDA	<u>\$ 26,616</u>	<u>\$ 34,115</u>	<u>\$ 60,731</u>

<sup>(1)</sup>As discussed in the Consolidated Overview section above, severance and other related termination costs were incurred as a result of the workforce reduction initiative implemented during the nine months ended September 30, 2010 in which approximately 60 positions were eliminated. Amounts exclude the termination costs related to stock compensation expense, which are included in non-cash stock compensation expense of the adjusted EBITDA reconciliation.

### *Free Cash Flow and Adjusted Free Cash Flow*

We define free cash flow as net income (loss) plus depreciation and amortization expense less capital expenditures. Adjusted free cash flow represents free cash flow excluding capital expenditures for network expansion. Free cash flow and adjusted free cash flow are used to measure operating cash flows available for corporate purposes after providing sufficient fixed asset additions to maintain current productive capacity.

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The following table is a reconciliation of net cash provided by operating activities to consolidated free cash flow and adjusted free cash flow for the quarters and nine-month periods ended September 30, 2011 and 2010:

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Net cash provided by operating activities	\$ 21,255	\$ 20,082	\$ 61,189	\$ 46,509
Less: Adjustments for all non-cash items and net changes in operating assets and liabilities	(20,612)	(18,678)	(60,870)	(45,105)
Net income	643	1,404	319	1,404
Add: Depreciation and amortization	15,810	15,680	47,942	46,048
Less: Capital expenditures	(18,658)	(12,857)	(50,781)	(39,271)
Free cash flow	\$ (2,205)	\$ 4,227	\$ (2,520)	\$ 8,181
Add: Capital expenditures for network expansion	7,455	329	15,890	1,285
Adjusted free cash flow	\$ 5,250	\$ 4,556	\$ 13,370	\$ 9,466
Free cash flow by segment:				
Broadband	\$ (6,904)	\$ (1,843)	\$ (14,809)	\$ (6,040)
Telecom	4,709	6,115	13,840	15,205
Corporate	(10)	(45)	(1,551)	(984)
Free cash flow	\$ (2,205)	\$ 4,227	\$ (2,520)	\$ 8,181
Adjusted free cash flow by segment:				
Broadband	\$ (404)	\$ (1,667)	\$ (804)	\$ (5,776)
Telecom	5,664	6,268	15,725	16,226
Corporate	(10)	(45)	(1,551)	(984)
Adjusted free cash flow	\$ 5,250	\$ 4,556	\$ 13,370	\$ 9,466

## Liquidity and Capital Resources

### Overview

We generate significant cash flows from operating activities. We believe that we will be able to meet our current and long-term liquidity and capital requirements through our cash flows from operating activities; existing cash and cash equivalents; and through available borrowings under our existing credit facilities. Our primary use of cash during 2011 was for capital expenditures and payments for long-term debt (including interest and refinancing costs). We anticipate continuing to use a substantial portion of our cash flow to fund our capital expenditures, invest in new business opportunities, fund network expansion, and meet scheduled payments of long-term debt. We may also fund the authorized share repurchase plan.

The following table summarizes our cash flows:

	Nine Months Ended September 30,		
	2011	2010	\$ Change
Cash Flows Provided By (Used In):			
Operating Activities	\$ 61,189	\$ 46,509	\$ 14,680
Investing Activities	(49,384)	(33,874)	(15,510)
Financing Activities	(5,810)	(16,909)	11,099
Increase (Decrease) in Cash and Cash Equivalents	\$ 5,995	\$ (4,274)	\$ 10,269

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### **Cash Flows Provided By Operating Activities**

Net cash provided by operating activities was \$61,189 during the nine-month period ended September 30, 2011. Adjustments to net income to arrive at cash provided by operating activities primarily included non-cash charges of (i) depreciation and amortization of \$47,942 due to capital investments principally in the Broadband segment and (ii) stock compensation expense of \$3,574. In addition, accrued compensation and other accrued liabilities increased \$5,348 related to the timing of payroll and the payment of various expenditures. Income tax receivable also decreased as a result of income tax refunds of \$1,263 received during the nine-month period ended September 30, 2011. Cash provided by operating activities was offset in part by interest payments for early termination fees of \$2,346 related to the repayment of our Series A and Series B Senior Notes during the nine-month period ended September 30, 2011, as discussed in Long-term Debt section below.

### **Cash Flows Used In Investing Activities**

Net cash used in investing activities was \$49,384 during the nine-month period ended September 30, 2011 and was primarily related to capital expenditures.

#### *Capital Expenditures*

Capital expenditures continue to be our primary recurring investing activity and were \$50,781 during the nine-month period ended September 30, 2011, an increase of \$11,510 from the same period last year. A significant portion of our capital spending has been invested into success-based capital and network expansion projects within our Broadband segment as we continue to expand and enhance the network within the Sacramento region and Kansas City area. In 2011, we have planned additional capital investments in our network through success-based capital projects and network expansion which will include the addition of 15,500 fiber marketable homes in the Kansas City area and the upgrade of 6,800 copper homes within the ILEC service territory to be video service capable. As of September 30, 2011, we added 9,600 of the planned fiber marketable homes in the Kansas City area and upgraded 5,800 of the planned homes in the ILEC territory. We also plan to continue our capital investment in business services in order to optimize new long-term revenue opportunities and support the growth in wireless backhaul services. Capital expenditures for 2011 are expected to be \$68,000 to \$72,000 of which approximately 32% are planned for network expansion and 50% are projected for success-based projects.

### **Cash Flows Provided By Financing Activities**

Net cash provided by financing activities consists primarily of our proceeds and principal payments on long-term borrowings.

#### *Long-term Debt*

In March 2011, we entered into a \$264,000 five-year senior secured Credit Agreement ("Credit Agreement") to replace our unsecured Third Amended and Restated Credit Agreement ("Previous Agreement") from September 2008. The proceeds from the Credit Agreement were used to replace all of the Previous Agreement and to repay the unsecured Series A and Series B Senior Notes issued in December 1998 and March 2003, respectively.

The Credit Agreement included (i) a \$34,000 Revolving Loan Facility, which includes a \$6,000 swingline loan commitment and a \$5,000 commitment for the issuances of letters of credit, each as a subfacility to the Revolving Loan Facility, (ii) a fully drawn \$40,000 Term A Loan Facility and (iii) a \$190,000 Term Loan B Commitment. On May 31, 2011, the Term Loan A Facility matured and converted to a Term Loan B borrowing thus increasing the Term Loan B Commitment by \$40,000 to \$230,000. The Term Loan B Commitment includes a delayed draw amount which allows for one or more additional advances not to exceed \$20,000. The delayed draw may be used solely for capital expenditures. All amounts outstanding on the Revolving Loan Facility and the Term Loan B Facility will be due on March 2, 2016.

In connection with entering into the Credit Agreement, we incurred \$3,565 in debt issuance costs of which \$301 was recognized during the quarter ended March 31, 2011. The remaining deferred debt issuance costs will be amortized over the term of the Credit Agreement. Debt issuance costs are recognized in other income (expense), interest expense in the condensed consolidated statements of income.

As of September 30, 2011, \$206,250 and zero were outstanding on the Term Loan B and Revolving Loan facilities, respectively. We had no short-term borrowings as of September 30, 2011.

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As of September 30, 2011, the Revolving Loan Facility's available balance was \$34,000 and the Term Loan B Facility had a delayed draw available of \$20,000.

Commencing on September 30, 2011, and on the last day of each quarter thereafter, principal payments for the Term Loan B Facility are due in equal quarterly amounts of \$3,750. In addition, we must make mandatory repayments under certain circumstances upon receipt of proceeds from insurance, asset dispositions, debt issuances and equity issuances.

### *Contractual Obligations*

There have been no significant changes to our "Contractual Obligations" table in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" included in our 2010 Annual Report on Form 10-K, other than those resulting from changes in the principal and interest payments on outstanding debt as described in the Long-term Debt section above. In addition, in June 2011, we entered into an interest rate swap agreement with a notional amount of \$75,000 with a fixed rate of 1.85%. As of September 30, 2011, future principal and interest payments on outstanding debt and interest rate swap obligations were as follows:

	<u>Less than 1 Year</u>	<u>1 - 3 Years</u>	<u>3-5 Years</u>	<u>Thereafter</u>	<u>Total</u>
Long-term debt	\$ 15,000	\$ 30,000	\$ 161,250	\$ -	\$ 206,250
Interest on long-term debt <sup>(1)</sup>	7,510	13,112	7,950	-	28,572
Interest rate swap obligation <sup>(2)</sup>	1,125	2,243	1,589	-	4,957

(1) Interest on long-term debt includes amounts due on variable rate debt. As the rates on our variable rate debt are subject to change, the rates in effect at September 30, 2011 were used in determining our future interest obligations. The weighted average rate of our variable rate debt was 3.63% at September 30, 2011.

(2) Under the interest rate swap agreement, we pay interest at a fixed rate of 1.85% and receive interest at a floating rate of three-month London Interbank Offered Rate. As the floating rate is subject to change, our future net obligation related to the interest rate swap agreement was determined based on the floating rate at September 30, 2011 of .375%.

### *Debt Covenants*

The Credit Agreement includes financial and operating covenants that may limit the incurrence of additional indebtedness, investments, the payment of dividends, the making of certain other restricted payments, transactions with affiliates, liens, mergers, asset sales and material changes in our business. The Credit Agreement also requires us to maintain certain financial ratios and minimum levels of tangible net worth.

Our financial covenants as defined in the Credit Agreement, measured quarterly, are as follows:

<u>Financial Covenant</u>	<u>Required Ratio Level</u>	<u>Actual Performance at September 30, 2011</u>
Leverage ratio	Not more than 3.00	2.44
Interest coverage ratio	Not less than 3.50	7.24
Consolidated net worth	Not less than \$200,000	\$287,946

### *Share Repurchase Program*

Our Board of Directors has authorized the repurchase of up to 3.5 million shares of our common stock. Shares are purchased from time to time in the open market or through privately negotiated transactions, subject to overall financial and market conditions. As of September 30, 2011, under the share repurchase program approximately 2.3 million shares of common stock have been repurchased and approximately 1.2 million additional outstanding shares remain authorized for repurchase by the Board of Directors. We repurchased approximately 55 thousand and 413 thousand shares during the quarter and nine-month period ended September 30, 2010. We did not repurchase any shares during the quarter or nine-month period ended September 30, 2011.

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### **Sufficiency of Cash Resources**

We had cash and cash equivalents at September 30, 2011 of \$8,932. As discussed in the Long-term Debt section above, we have additional long-term borrowing capacity of approximately \$54,000 available to us through our Revolving Loan facility and the delayed draw of the Term B facility. We believe our operating cash flows and our borrowing capacity are sufficient to satisfy our liquidity requirements for the next twelve months, while maintaining adequate cash and cash equivalents.

Our most significant use of funds for the remainder of 2011 is expected to be for (i) budgeted capital expenditures of \$17,000 to \$21,000, (ii) scheduled payments of long-term debt of \$3,750, (iii) anticipated interest payments of approximately \$2,200 and (iv) cash dividends of approximately \$1,400, as discussed below. As discussed above, throughout the year we may repurchase shares of the Company's common stock in the open market at the prevailing market price up to an amount authorized by the Board of Directors.

In March 2011, our Board of Directors approved a cash dividend anticipated to be paid on a quarterly basis. On October 26, 2011, our Board of Directors declared a cash dividend of \$0.10 per share payable on December 15, 2011 to shareholders of record at the close of business on November 30, 2011. We expect the dividend could be as much as \$1,400 based on the number of outstanding shares. We currently expect to pay comparable cash dividends in the future; however, changes in our dividend program will depend on our earnings, capital requirements, financial condition, debt covenant compliance and other factors considered relevant by our Board of Directors.

A portion of the 2011 budgeted capital expenditures is at our discretion and dependent upon our working capital position, operating cash flows and ability to borrow. We can modify our planned construction and commitments if the results of operations or available capital so require. A significant portion of our 2011 budgeted capital expenditures are success based and is partially dependent on our ability to manage our growth and expansion. We are required to comply with our cable franchise agreements to continue our build-out in the franchise areas.

#### *Defined Benefit Pension Plan*

As required, we contribute to our frozen noncontributory defined benefit pension plan (the "Pension Plan"), Supplemental Executive Retirement Plan and certain post-retirement benefits other than pensions ("Other Benefits Plan") (collectively the "Plans"), which provide retirement benefits to certain eligible employees. Contributions are intended to provide for benefits attributed to service to date. Our funding policy is to contribute annually an actuarially determined amount consistent with applicable federal income tax regulations.

The cost to maintain our Pension Plan and future funding requirements are affected by several factors including the expected return on investment of the assets held by the Pension Plan, changes in the discount rate used to calculate pension expense and the amortization of unrecognized gains and losses. Returns generated on Plan assets have historically funded a significant portion of the benefits paid under the Pension Plan. We estimate the long-term rate of return of Plan assets will be 8.0%. However, the significant decline in the equity markets precipitated by the credit crisis in recent years has negatively affected the value of our Pension Plan assets. The Pension Plan invests in marketable equity securities which are exposed to changes in the financial markets. If the financial markets experience a downturn and returns fall below our estimate, as seen in recent years, we could be required to make a material contribution to the Pension Plan, which could adversely affect our cash flows from operations.

Our minimum funding requirement for 2011 related to the Pension Plan is expected to be \$5,797. However, due to a carryover balance of \$2,042 and the timing of the quarterly installments, we are not required to make a cash contribution until January 2012. We will continue to evaluate the future funding requirements of the Plans and fund them as necessary. See Note 6 for a more detailed discussion regarding our Pension Plan and Other Benefits Plan.

#### *Income Taxes*

The timing of cash payments for income taxes, which is governed by the Internal Revenue Service and other taxing jurisdictions, will differ from the timing of recording tax expense and deferred income taxes, which are reported in accordance with GAAP. For example, tax laws currently in effect for 2010 through 2012 regarding accelerated or "bonus" depreciation for tax reporting may result in less cash payments than the GAAP tax expense. Acceleration of tax deductions could eventually result in situations where cash payments will exceed GAAP tax expense. Changes in tax laws create uncertainty as to when or if this situation will occur within the next three years.

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Our deferred tax assets are expected to be realized through the reversal of deferred tax liabilities and through the generation of future taxable income from ordinary and recurring operations. Deferred tax assets that are dependent on specific business segments generating future taxable income were determined to be more likely than not to be realized since those segments have at least 10 years in which to generate the estimated required taxable income. Approximately \$1,500 of future taxable income is estimated to be required to realize these deferred tax assets.

Historically, pre-tax earnings for financial reporting purposes have exceeded the amount of taxable income reported for income tax purposes. This has primarily occurred due to the acceleration of depreciation deductions for income tax reporting purposes.

### **Regulatory Matters**

As discussed more fully in the Regulatory Matters section above, the CPUC issued a final decision which phased down our annual CHCF interim draw by approximately \$2,040 annually, over a 5-year period which will end January 1, 2012. In addition, SureWest Telephone's intrastate access element, the TIC, was eliminated effective January 1, 2011 in accordance with previous CPUC final decisions. As a result of the elimination of the TIC, the reduction in our 2011 intrastate access revenues will be approximately \$2,050.

### **Critical Accounting Estimates**

Our condensed consolidated financial statements and accompanying notes are prepared in accordance with GAAP. Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expenses. These estimates and assumptions are affected by management's application of accounting policies. Our judgments are based on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making estimates about the carrying values of assets and liabilities that are not readily apparent from other sources. For a full discussion of our accounting estimates and assumptions that we have identified as critical in the preparation of our condensed consolidated financial statements, refer to our 2010 Annual Report on Form 10-K.

### **Recently Issued Accounting Pronouncements**

In September 2011, the Financial Accounting Standards Board ("FASB") issued the Accounting Standards Update ("ASU") to permit an entity the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the first step of the two-step goodwill impairment test. Accordingly, based on the option created by the amended guidance, the calculation of a reporting unit's fair value is not required unless, as a result of the qualitative assessment, it is more likely than not that fair value of the reporting unit is less than its carrying amount. The amended guidance, which should be applied prospectively, becomes effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. We are currently evaluating the impact this update will have on our condensed consolidated financial statements.

In May 2011, as part of ongoing efforts with the International Accounting Standards Board to achieve convergence, the FASB issued the ASU on fair value measurements and disclosures to (i) clarify the application of existing fair value measurement and disclosure requirements and (ii) change a particular principle or requirement for measuring fair value or disclosing information about fair value measurements. The amendments in this ASU are effective for public entities for interim and annual periods beginning after December 15, 2011 and should be applied prospectively, with early application not permitted. We are currently evaluating the impact this update will have on our condensed consolidated financial statements.

In June 2011, the financial statement presentation of comprehensive income was amended by an ASU issued by the FASB to (i) eliminate the option to present the components of other comprehensive income ("OCI") in the statement of changes in stockholder's equity, (ii) require presentation of net income and OCI and their respective components either in a single continuous statement or in two separate but consecutive statements and (iii) require presentation of reclassification adjustments on the face of the statement. The amendments in this ASU do not change (i) the items that must be reported in OCI or when an item of OCI must be reclassified to net income or (ii) the option for an entity to present components of OCI either net of related tax effects or before related tax effects. Amendments to comprehensive income should be applied retrospectively and become effective for public entities for interim and annual periods beginning after December 15, 2011 with early adoption permitted. We are currently evaluating the impact this update will have on our condensed consolidated financial statements.

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### **Recently Adopted Accounting Pronouncements**

On January 1, 2011, we adopted the ASU regarding business combinations. The updated guidance requires a public entity to disclose pro forma revenue and earnings for a business combination occurring in the current year as though the business combination occurred as of the beginning of the year or, if comparative statements are presented, pro forma amounts are required to be presented as though the business combination took place as of the beginning of the comparative year. In addition, it also expands the supplemental pro forma disclosures to include a description of the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combination included in the reported pro forma revenue and earnings. The provisions of this updated guidance will be applied prospectively to business combinations consummated subsequent to January 1, 2011. Our adoption of this guidance did not impact our condensed consolidated financial position or results of operations.

On January 1, 2011, we prospectively adopted the ASU that clarifies when the circumstances under which step 2 of the goodwill impairment test must be performed for reporting units with zero or negative carrying amounts and the qualitative factors to be taken into account when performing step 2 in determining whether it is more likely than not that an impairment exists. The adoption of this guidance did not impact our condensed consolidated financial position or results of operations.

On January 1, 2011, we prospectively adopted the ASU regarding revenue recognition for multiple-deliverable arrangements. The updated guidance provides for a new methodology for establishing the fair value for a deliverable in a multiple-element arrangement. When vendor specific objective or third-party evidence for deliverable in a multiple-element arrangement cannot be determined, an enterprise is required to develop a best estimate of the selling price of separate deliverables and to allocate the arrangement consideration using the relative selling price method. The adoption of this guidance did not have a material impact on our condensed consolidated financial position or results of operations.

### **Regulatory and Legal Matters**

Significant portions of our telecommunication rates and charges are subject to regulation by the FCC and state commissions. Many of these rates and charges are based on various tariffs or service guides filed by SureWest and others, including those filed by the NECA for common line charges. Pending and future regulatory actions, with respect to these and other matters and the filing of new or amended tariffs or service guides, may have a material impact on our consolidated financial position and results of operations. In addition, the emergence of a range of products and services that operate partially or entirely outside traditional regulatory frameworks but that compete with our regulated service offerings has created new challenges for both us and the regulators.

Our consolidated financial condition and results of operations have been and will be affected by recent and future proceedings before the state commissions and FCC. Pending before the FCC and state commissions are proceedings that, among other things, are considering:

- additional rules governing the opening of markets to competition and the regulation of our business and of competing telecommunications providers;
- the nature and extent of the compensation, if any, to be paid by carriers and other providers to one another for network use, and the sums to be recovered through end users and other sources;
- the goals and definition of universal telephone service in a changing environment, including examination of subsidy/support mechanisms for different carriers (including ILECs) and covering various geographic areas;
- rules that will provide non-discriminatory access by competing service providers to the network capabilities of local exchange carriers; and
- the regulated rates and earnings of SureWest Telephone.

There are a number of other pending and anticipated regulatory proceedings occurring at the federal and state levels that may have a material impact on SureWest Telephone and also on subsidiaries in the Broadband segment. These regulatory proceedings include newer issues, such as promotion of broadband deployment and regulation of IP-enabled services. The outcomes and impact of these proceedings and related court matters on the Telecom segment, the Broadband segment and the Company as a whole cannot be determined at this time.

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

The primary objective of the following information is to provide forward-looking quantitative and qualitative information about our potential exposure to market risks. The term "market risk" refers to the risk of loss arising from adverse changes in interest rates and credit risk. The disclosure is not meant to be a precise indicator of expected future losses, but rather an indicator of reasonably possible losses. Our exposure to market risk is primarily related to the impact of interest rate fluctuations of our debt obligations.

#### **Interest Rate Risks in our Debt Obligations**

We enter into debt obligations to fund acquisitions, operations and planned capital expenditures. In March 2011, we entered into a new long-term \$264,000 Credit Agreement, of which at September 30, 2011, \$206,250 was outstanding and all of which bore interest at a London Interbank Offered Rate ("LIBOR") based rate. As of September 30, 2011, the weighted average rate was 3.63%.

For variable-rate debt, interest rate changes generally impact our results of operations and operating cash flows, assuming other factors are held constant. Based on our variable-rate debt outstanding at September 30, 2011, each 25 basis point increase in the level of interest rates would increase our annual interest expense and related cash payments by approximately \$516. Such potential increases are based on certain simplifying assumptions, including a constant level of variable-rate debt and an immediate, across-the-board increase in the level of interest rates with no other subsequent changes for the remainder of the period.

To manage the impact of rising interest rates associated with our long-term debt, we entered into one interest rate swap and two interest rate caps during June 2011. The interest rate swap was effective June 30, 2011 and will end March 2, 2016 with a cancellation provision on June 30, 2014. The swap agreement is on a notional amount of \$75,000 at 1.85%. This fixes the total interest expense on \$75,000 of our outstanding long-term debt at 5.10%, which includes the fixed rate of 185 basis points plus our applicable interest margin of 325 basis points. The interest rate cap agreements each have a notional amount of \$25,000 with a 2.00% strike price and are effective June 30, 2011 through June 30, 2014 and August 31, 2011 through March 2, 2014, respectively.

We will continually monitor our interest rate risk exposures and may consider entering into additional derivative instruments to manage the impact of the interest rate changes on our results of operations and operating cash flows.

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

#### **Evaluation of disclosure controls and procedures**

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based upon, and as of the date of this evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective, at the reasonable assurance level, to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act is authorized, recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms.

#### **Change in internal control over financial reporting**

During the nine-month period ended September 30, 2011, our Senior Vice President and Chief Operating Officer, Fred A. Arcuri announced his retirement from the Company effective April 15, 2011. Our Vice President and General Manager of Operations, California, Scott K. Barber, assumed the position on that same date. In addition, the responsibilities of all of the Vice Presidents were re-evaluated and certain tasks were reassigned as deemed appropriate. We believe that the change in officers and changes in responsibilities between officers will not have a material effect on our internal controls over financial reporting or disclosure controls and procedures. We will continue to monitor this change in officers and responsibilities for any potential impacts to our internal controls.

Except for the items discussed above, there has been no change in our internal control over financial reporting during the quarter and nine-month period ended September 30, 2011.

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**Limitations on the effectiveness of controls**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to our management, Board of Directors and Audit Committee regarding the reliability of financial reporting and the preparation of published financial statements in accordance with generally accepted accounting principles.

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**PART II –OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.**

Refer to Notes 9 and 10 to our condensed consolidated financial statements of the Quarterly Report on Form 10-Q for a discussion of recent developments related to our regulatory and legal proceedings.

**ITEM 6. EXHIBITS.**

(a) Index to Exhibits.

<b>Exhibit No.</b>	<b>Description</b>	<b>Method of Filing</b>
31.1	Certification of Steven C. Oldham, President and Chief Executive Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31.2	Certification of Dan T. Bessey, Vice President and Chief Financial Officer, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.1	Certification of Steven C. Oldham, President and Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	*
32.2	Certification of Dan T. Bessey, Vice President and Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	*
101.INS	XBRL Instance Document	§
101.SCH	XBRL Taxonomy Extension Schema Document	§
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	§
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	§
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	§
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	§

\* Furnished, not filed.

§ This exhibit will not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934 (15 U.S.C. 78r), or otherwise subject to the liability of that section. Such exhibit will not be deemed to be incorporated by reference into any filing under the Securities Act of Securities Exchange Act, except to the extent that the Company specifically incorporates it by reference.

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**SIGNATURES**

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

SUREWEST COMMUNICATIONS  
(Registrant)

By: /s/ STEVEN C. OLDHAM  
Steven C. Oldham,  
President and Chief  
Executive Officer

By: /s/ DAN T. BESSEY  
Dan T. Bessey,  
Vice President and Chief  
Financial Officer

Date: October 28, 2011

## CERTIFICATION

I, Steven C. Oldham, certify that:

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

Date: October 28, 2011

By: /s/ Steven C. Oldham  
Steven C. Oldham,  
President and  
Chief Executive Officer

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## CERTIFICATION

I, Dan T. Bessey, certify that:

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

Date: October 28, 2011

By: /s/ Dan T. Bessey  
Dan T. Bessey,  
Vice President and  
Chief Financial Officer

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CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of SureWest Communications (the "Company"), on Form 10-Q for the period ended September 30, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, as the Chief Executive Officer of the Company, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 28, 2011

By: /s/ Steven C. Oldham  
Steven C. Oldham,  
President and  
Chief Executive Officer

A signed original of this written statement required by Section 906 has been provided to SureWest Communications and will be retained by SureWest Communications and furnished to the Securities and Exchange Commission or its staff upon request.

The foregoing certificate is being furnished to the Securities and Exchange Commission as an exhibit to the Form 10-Q and shall not be considered filed as part of the Form 10-Q.

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CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of SureWest Communications (the "Company"), on Form 10-Q for the period ended September 30, 2011 as filed with the Securities and Exchange Commission of the date hereof (the "Report"), the undersigned, as the Chief Financial Officer of the Company, hereby certifies pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: October 28, 2011

By: /s/ Dan T. Bessey  
Dan T. Bessey,  
Vice President and  
Chief Financial Officer

A signed original of this written statement required by Section 906 has been provided to SureWest Communications and will be retained by SureWest Communications and furnished to the Securities and Exchange Commission or its staff upon request.

The foregoing certificate is being furnished to the Securities and Exchange Commission as an exhibit to the Form 10-Q and shall not be considered filed as part of the Form 10-Q.

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