SUREWEST COMMUNICATIONS (SURW)

10-Q
Quarterly report pursuant to sections 13 or 15(d)
Filed on 05/02/2012
Filed Period 03/31/2012

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

FORM 10-Q

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

For the quarterly period ended March 31, 2012

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	68-0365195
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
8150 Industrial Avenue, Building A, Roseville, California	95678
(Address of principal executive offices)	(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 X 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 X 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 X

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 X

On April 17, 2012, the registrant had 14,330,035 shares of Common Stock outstanding.

TABLE OF CONTENTS

PART 1 — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

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

	Quarter Ended March 31, 2012	Quarter Ended March 31, 2011
Operating revenues:		
Broadband	$ 49,987	$ 45,379
Telecom	12,771	15,176
Total operating revenues	62,758	60,555
Operating expenses:		
Cost of services and products (exclusive of depreciation and amortization)	29,723	27,261
Customer operations and selling	8,163	6,983
General and administrative	11,120	8,548
Depreciation and amortization	15,946	15,775
Total operating expenses	64,952	58,567
Income (loss) from operations	(2,194)	1,988
Other income (expense):		
Interest income	25	15
Interest expense	(2,213)	(4,416)
Other, net	(154)	207
Total other income (expense), net	(2,342)	(4,194)
Loss before income taxes	(4,536)	(2,206)
Income tax benefit	(622)	(562)
Net loss	$ (3,914)	$ (1,644)
Basic and diluted loss per common share	$ (0.28)	$ (0.12)
Shares of common stock used to calculate basic and diluted loss per share	14,036	13,784
Dividends declared per common share	$ 0.10	$ 0.08

See accompanying notes.

SUREWEST COMMUNICATIONS
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(Unaudited; Amounts in thousands)

	Quarter Ended March 31, 2012	Quarter Ended March 31, 2011
Net loss	$ (3,914)	$ (1,644)
Other comprehensive loss:		
Derivative instruments designated as cash flow hedges:		
Unrealized loss on cash flow hedges, net of tax	(29)	–
Loss reclassified to net income, net of tax	22	–
Available-for-sale investments:		
Unrealized loss on available-for-sale investments, net of tax	–	(3)
Reclassification adjustment for gain included in net loss, net of tax	–	(57)
Other comprehensive loss	(7)	(60)
Comprehensive loss	$ (3,921)	$ (1,704)

See accompanying notes.

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

	March 31, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$ 5,446	$ 4,208
Accounts receivable, net	18,899	21,540
Income tax receivable	123	280
Prepaid expenses	2,974	2,912
Deferred income taxes	2,299	2,226
Assets held for sale	4,756	4,756
Total current assets	34,497	35,922
Property, plant and equipment, net	523,012	522,790
Intangible and other assets:		
Customer relationships, net	1,114	1,417
Goodwill	45,814	45,814
Deferred charges and other assets	5,942	6,133
	52,870	53,364
	$ 610,379	$ 612,076
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 7,500	$ 7,500
Accounts payable	3,443	4,315
Other accrued liabilities	16,699	16,783
Advance billings and deferred revenues	8,170	8,051
Accrued compensation	7,679	7,593
Total current liabilities	43,491	44,242
Long-term debt	200,000	196,875
Deferred income taxes	48,569	49,126
Accrued pension and other post-retirement benefits	54,957	54,354
Other liabilities and deferred revenues	6,662	6,784
Commitments and contingencies		
Shareholders' equity:		
Common stock, without par value; 100,000 shares authorized, 14,330 and 14,060 shares issued and outstanding at March 31, 2012 and December 31, 2011, respectively	147,904	146,498
Accumulated other comprehensive loss	(27,777)	(27,770)
Retained earnings	136,573	141,967
Total shareholders' equity	256,700	260,695
	$ 610,379	$ 612,076

See accompanying notes.

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

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Net cash provided by operating activities	$ 15,490	$ 19,372
Cash flows from investing activities:		
Capital expenditures for property, plant and equipment	(16,100)	(11,452)
Proceeds from sale of property and equipment	156	225
Proceeds from sale of available-for-sale securities	–	783
Purchases of available-for-sale securities	–	(10)
Net cash used in investing activities	(15,944)	(10,454)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	5,000	170,000
Principal payments on long-term debt	(1,875)	(165,409)
Payment of debt issuance costs	–	(3,565)
Dividends paid	(1,433)	–
Net cash provided by financing activities	1,692	1,026
Increase in cash and cash equivalents	1,238	9,944
Cash and cash equivalents at beginning of period	4,208	2,937
Cash and cash equivalents at end of period	$ 5,446	$ 12,881

See accompanying notes.

(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.

On February 5, 2012, we entered into an Agreement and Plan of Merger ("the Merger Agreement") by and among SureWest, Consolidated Communications Holdings, Inc., a Delaware corporation, ("Consolidated"), WH Acquisition Corp., a California corporation and wholly owned subsidiary of Consolidated ("Merger Sub I") and WH Acquisition II Corp., a California corporation and wholly owned subsidiary of Consolidated ("Merger Sub II"), pursuant to which Merger Sub I will merge with and into SureWest, (the "First Merger") and following consummation of the First Merger, SureWest will merge with and into Merger Sub II, and Merger Sub II shall be the surviving corporation. See Note 10 for further details regarding this pending merger.

In the opinion of management, the accompanying condensed consolidated balance sheets and related interim statements of operations, comprehensive loss 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 the accompanying notes to the financial statements ("Notes") thereto included in our 2011 Annual Report on Form 10-K filed with the SEC.

Recent Developments

Assets Held For Sale

Assets held for sale consist of certain real estate assets that are currently marketed for sale. These regulated assets, which are included in the Telecommunications ("Telecom") segment, include 21 acres of undeveloped land and an office building.

The following is the carrying value of the assets held for sale as of March 31, 2012 and December 31, 2011:

Undeveloped land	$	1,556
Office building		3,200
	$	4,756

We continue to actively market the undeveloped land and expect it to sell in the range of $2,000 to $5,000. We evaluated the fair value of the land at March 31, 2012 and determined that the estimated fair value less estimated selling costs exceeds its carrying value; therefore, no impairment charge was recorded during the quarter ended March 31, 2012.

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 was expected to close by the end of the second quarter of 2012; however, during the quarter ended March 31, 2012, the sales agreement was terminated. We continue to actively market the office building for sale. There was no change to the estimated fair value of the assets held for sale as of March 31, 2012; therefore, no additional impairment charge was recorded during the quarter ended March 31, 2012.

Statements of Cash Flow Information

Noncash Financing Activities

In March 2011, our Board of Directors approved a cash dividend of $0.08 per share. The dividend was paid on June 15, 2011 to shareholders of record at the close of business on May 16, 2011. In connection with the approval of the cash dividend, we recorded a current liability of approximately $1,141, which was included in other accrued liabilities on our condensed consolidated balance sheet as of March 31, 2011. The accrued liability for the cash dividend represents a noncash financing activity during the quarter ended March 31, 2011. We did not have any noncash financing activities during the quarter ended March 31, 2012.

Recently Issued Accounting Pronouncements

There was no newly issued accounting guidance during the quarter ended March 31, 2012.

Recently Adopted Accounting Pronouncements

On January 1, 2012 we adopted the Accounting Standards Update ("ASU") on fair value measurements and disclosures. The updated guidance (i) clarifies the application of existing fair value measurement and disclosure requirements and (ii) changes a particular principle or requirement for measuring fair value or disclosing information about fair value measurements. Our adoption of this guidance did not impact our consolidated financial position or results of operations.

On January 1, 2012, we adopted an ASU that amended the presentation of comprehensive income 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. In December 2011, the Financial Accounting Standards Board issued an ASU to indefinitely defer the effective date of the provision pertaining only to the presentation of reclassification adjustments out of accumulated other OCI and reinstated the previous requirements to present reclassification adjustments either on the face of the statement in which OCI is reported or to disclose them in a note to the financial statements. Our adoption of this guidance did not impact our 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 months ended March 31, 2012 and 2011 exclude potential common shares of 618 and 548, respectively, 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 and divided by the closing share price. Any fractional stock units resulting from such calculation are included in the additional stock units.

2. FAIR VALUE MEASUREMENTS & FINANCIAL INSTRUMENTS

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 $1,482 and $1,430 in cost method investments which were included in other long-term assets in the condensed consolidated balance sheets as of March 31, 2012 and December 31, 2011, 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 March 31, 2012 and December 31, 2011.

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.

The following tables summarize our financial assets and liabilities measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011:

	As of March 31, 2012			
	Total	**Level 1**	**Level 2**	**Level 3**
Assets				
Interest rate caps	$ 23	$ –	$ 23	$ –
Liabilities				
Interest rate swap	$ 1,630	$ –	$ 1,630	$ –

	As of December 31, 2011			
	Total	**Level 1**	**Level 2**	**Level 3**
Assets				
Interest rate caps	$ 72	$ –	$ 72	$ –
Liabilities				
Interest rate swap	$ 1,505	$ –	$ 1,505	$ –

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 March 31, 2012 and December 31, 2011. 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. The fair value of the long-term debt, using Level 2 inputs of similarly traded liabilities as of March 31, 2012 and December 31, 2011 was $205,780 and $202,793, respectively.

3. CREDIT ARRANGEMENTS

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

	Weighted Average Interest Rates				
	March 31, 2012	December 31, 2011	Maturity Date	March 31, 2012	December 31, 2011
Secured Term Loan B Facility	3.33%	3.34%	March 2016	$ 202,500	$ 204,375
Secured Revolving Loan Facility	3.12%	–	March 2016	5,000	-
Total long-term debt				207,500	204,375
Less current portion				7,500	7,500
Total long-term debt, net of current				$ 200,000	$ 196,875

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.

The Credit Agreement includes (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. All amounts outstanding on the Revolving Loan Facility and the Term Loan B Facility will be due on March 2, 2016. As of March 31, 2012, $5,000 was outstanding under the Revolving Loan Facility.

The Term Loan B Commitment included a delayed draw amount which allowed for one or more additional advances not to exceed $20,000. The delayed draw was to be used solely for capital expenditures. During the quarter ended March 31, 2012, we determined that we would not utilize our $20,000 delayed draw prior to the end of the Term Loan B Availability Period of September 1, 2012. Accordingly, we cancelled our delayed draw effective March 5, 2012.

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 are being 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 operations during the quarter ended March 31, 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.

Borrowings under the Credit Agreement (other than the swingline loan) 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.

In November 2011, we entered into a Second Amendment to Credit Agreement ("Amendment") to amend certain terms of the Credit Agreement. The Amendment reduced the quarterly principal payments from $3,750 to $1,875, commencing on December 31, 2011 and on the last day of each quarter thereafter, provided that our Leverage Ratio is less than 2.60:1.0 for the preceding two consecutive fiscal quarters. The Amendment also reduced the applicable LIBOR margin and the bank's base rate margin by 50 basis points per annum commencing in November 2011.

At March 31, 2012, the aggregate maturities of long-term debt are expected to be (i) $5,625 in the remainder of 2012, (ii) $7,500 annually in 2013 through 2015 and (ii) $179,375 in 2016 for a total of $207,500.

Our obligations under the Credit Agreement are secured by a first priority security interest in essentially all our currently existing 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:

Financial Covenant	**Required Ratio Level**	**Actual Performance at March 31, 2012**
Leverage ratio	Not more than 3.00	2.48
Interest coverage ratio	Not less than 3.50	8.93
Consolidated net worth	Not less than $200,000	$284,477

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, at least quarterly. 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.

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 is immediately recognized as interest expense in the condensed consolidated statements of operations. 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% and is benchmarked based on the three month LIBOR. The objective is to effectively fix the total interest expense on $75,000 of our outstanding long-term debt at 4.60% over the term of the swap, which includes the fixed rate of 185 basis points plus our current applicable interest margin of 275 basis points at March 31, 2012. During the life of the swap, we are still exposed to variability in interest expense to the extent our applicable interest margin changes. The interest rate swap agreement was effective June 30, 2011 and ends March 2, 2016, but includes a cancellation provision which provides us the right to cancel the agreement 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 through June 30, 2014 and 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 agreements.

During the quarter ended December 31, 2011, our prospective assessment of hedge effectiveness indicated the interest rate swap agreement was ineffective in offsetting the future changes in expected cash flows over the remaining term of the agreement. Therefore, changes in the fair value of the interest rate swap agreement are being recognized in interest expense in the condensed consolidated statement of operations. Prior to becoming ineffective, the effective portion of the changes in fair value of the interest rate swap agreement were recognized in accumulated other comprehensive loss. The balance of the unrealized loss included in accumulated other comprehensive loss related to the ineffective swap agreement is being amortized to interest expense over the remaining term of the agreement. If it becomes probable that we will not have variable-rate debt through the term of the agreement, the remaining unrealized loss in accumulated other comprehensive loss will be immediately recognized as interest expense in the condensed consolidated statement of operations.

The fair values of derivative instruments included in the condensed consolidated balance sheets at March 31, 2012 and December 31, 2011 consisted of:

	Classification	Fair Value March 31, 2012	Fair Value December 31, 2011
Asset derivatives			
Interest rate caps	Deferred charges and other assets	$ 23	$ 72
Liability derivatives			
Interest rate swap	Other liabilities and deferred revenues	$ 1,630	$ 1,505

The effect of derivative instruments on the condensed consolidated statements of operations, before tax effects, for the three months ended March 31, 2012 consisted of:

	Loss Recognized in OCI on Derivatives (Effective Portion)	Location of Gain (Loss) (Effective Portion)	Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Location of Gain (Loss) (Ineffective Portion)	Gain (Loss) Recognized in Income on Derivatives (Ineffective Portion)
Interest rate swap	$ -	Interest expense	$ (7)	Interest expense	$ (124)
Interest rate caps	(48)	Interest expense	(30)	Interest expense	-
Total	$ (48)		$ (37)		$ (124)

We did not have any derivative instruments during the three months ended March 31, 2011. We expect to reclassify $182 of the net loss included in accumulated other comprehensive loss into earnings during the next 12 months.

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 2.4 million shares of our common stock are authorized for issuance, including those outstanding as of March 31, 2012.

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 quarters ended March 31, 2012 and 2011:

	Three Months Ended March 31,			
	2012	Grant Date FairValue	2011	Grant Date Fair Value
RSAs Granted	192,773	$ 12.22	169,058	$ 10.78
RSUs Granted	90,828	$ 12.22	78,614	$ 10.78
Total	283,601		247,672	

The following summarizes the time-based RSA and RSU stock activity during the quarter ended March 31, 2012:

	Shares	Weighted Average Grant Date Fair Value
Nonvested-January 1, 2012	380,153	$11.19
Granted	283,601	$12.22
Vested	(29,454)	$12.22
Forfeited	–	
Nonvested-March 31, 2012	634,300	$11.61

The total fair value of the RSAs and RSUs that vested during the quarters ended March 31, 2012 and 2011 was $360 and $216, respectively.

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 an eleven trading day period 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.

The following table summarizes the grants of PSAs and PSUs that occurred under the Stock Plan during the quarters ended March 31, 2012 and 2011.

	Three Months Ended March 31, 2012			
	2012	FairValue	2011	FairValue
PSAs Granted	76,837	$ 8.25	56,341	$ 8.32
PSUs Granted	–	$ –	19,712	$ 8.32
Total	76,837		76,053	

The following table summarizes the PSA and PSU activity during the quarter ended March 31, 2012:

	Shares	Weighted Average Grant Date Fair Value
Nonvested-January 1, 2012	72,132	$ 9.36
Granted	76,837	$ 8.25
Vested	–	
Forfeited	–	
Nonvested-March 31, 2012	148,969	$ 8.79

The total fair value of the PSAs and PSUs that vested during the quarter ended March 31, 2012 was $634.

Share Based Compensation Expense

The following table summarizes total compensation costs recognized for share-based payments during the quarters ended March 31, 2012 and 2011:

	Quarter Ended March 31,	
	2012	2011
RSAs[1]	$ 565	$ 1,115
RSUs	566	390
PSAs	215	102
PSUs	13	38
Total	$ 1,359	$ 1,645

[1] 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 quarter ended March 31, 2011 included approximately $647 related to the acceleration of unvested, time-based RSAs.

As of March 31, 2012, total unrecognized compensation costs related to nonvested RSAs, RSUs, PSAs, and PSUs was $7,127 and will be recognized over a weighted-average period of approximately 2.66 years.

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:

	Quarter Ended March 31,	
	2012	2011
Interest cost on projected benefit obligation	$ 1,642	$ 1,728
Expected return on plan assets	(1,611)	(1,875)
Amortization of net actuarial loss	1,279	581
Net periodic pension expense	$ 1,310	$ 434

Net periodic benefit costs related to the Other Benefits Plan were not significant to our condensed consolidated financial statements for the quarters ended March 31, 2012 and 2011.

Cash Flows

Contributions

We expect to contribute $8,462 to our Pension Plan in 2012. As of March 31, 2012, we have contributed $578 of the annual contribution to the Pension Plan.

7. INCOME TAXES

Our effective federal income tax rates were 13.7% and 25.5% for the three-month periods ended March 31, 2012 and 2011, respectively. For the three-month period ended March 31, 2012, our actual tax expense differed from the federal statutory rate primarily due to permanent differences related to the transaction costs, as well as the reversal of unrecognized tax benefits and a change to state deferred tax expense attributable to apportionment changes.

As of March 31, 2012, we did not have a material liability for uncertain tax positions. During the three months ended March 31, 2012, we recorded a decrease of $97 to our unrecognized tax benefits, which increased our tax benefit by a corresponding amount, due to the expirations of a statute of limitations. We do not expect any material changes in our uncertain tax positions for the remainder of 2012.

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; certain property, plant, and equipment; and miscellaneous other assets, which are not allocated to the segments. However, the interest income associated with cash held by Corporate Operations is included in the results of the operations of our segments.

Our business segment information is as follows:

	Broadband	Telecom	Intercompany Eliminations	Consolidated
For the three months ended March 31, 2012:				
Operating revenues from external customers	$ 49,987	$ 12,771	$ –	$ 62,758
Intersegment revenues	191	5,484	(5,675)	–
Operating expenses				
Cost of services and products*	28,907	5,867	(5,051)	29,723
Customer operations and selling	5,843	2,820	(500)	8,163
General and administrative	7,421	3,823	(124)	11,120
Depreciation and amortization	12,772	3,174	–	15,946
Income (loss) from operations	(4,765)	2,571	–	(2,194)
Net income (loss)	$ (5,022)	$ 1,108	$ –	$ (3,914)

*Exclusive of depreciation and amortization

	Broadband		Telecom		Intercompany Eliminations		Consolidated
For the three months ended March 31, 2011:							
Operating revenues from external customers	$	45,379	$	15,176	$	–	$	60,555
Intersegment revenues		160		5,296		(5,456)		–
Operating expenses								
Cost of services and products*		26,323		5,752		(4,814)		27,261
Customer operations and selling		5,051		2,448		(516)		6,983
General and administrative		4,963		3,711		(126)		8,548
Depreciation and amortization		12,688		3,087		–		15,775
Income (loss) from operations		(3,486)		5,474		–		1,988
Net income (loss)	$	(4,405)	$	2,761	$	–	$	(1,644)

*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 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.

The FCC requires SureWest Telephone to prepare and submit periodic cost separation studies related to certain NECA CL accounts receivable balances. As a result of the cost separation filings, SureWest Telephone may change its estimates for certain NECA CL accounts receivable balances related to the prior year monitoring period. During the quarter ended March 31, 2012, this change in estimate decreased our consolidated revenues and increased our loss from operations by $348 and increased our net loss by $213 ($0.02 per share), respectively. We did not record any significant changes in estimates related to prior year monitoring periods during the quarter ended March 31, 2011.

California Public Utility Commission ("CPUC") Matters

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, (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. 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 Incumbent Local Exchange Carriers in the state, including SureWest Telephone. Subsequently, the CPUC issued a ruling temporarily deferring the proceeding. The status on when the CPUC may open this proceeding is unclear and on hold at this time. The CPUC's actions in this and future proceedings could lead to new rules and an increase in government regulation. The Company will continue to monitor this matter.

In September 2007, the CPUC issued Decision 07-09-002 which provided for SureWest Telephone to phase-down its $11,500 interim annual California High Cost Fund draw ("interim draw") by $2,040 over a five-year period, from 2007 to 2011. As a result of the completion of the phase-down, we did not receive an interim draw during the quarter ended March 31, 2012 which resulted in a decrease to access revenues of $510 during the quarter ended March 31, 2012 compared to the same period in 2011.

10. PENDING MERGER

On February 5, 2012, we entered into an Agreement and Plan of Merger ("the Merger Agreement") by and among SureWest, Consolidated Communications Holdings, Inc., a Delaware corporation, ("Consolidated"), WH Acquisition Corp., a California corporation and wholly owned subsidiary of Consolidated ("Merger Sub I") and WH Acquisition II Corp., a California corporation and wholly owned subsidiary of Consolidated ("Merger Sub II"), pursuant to which Merger Sub I will merge with and into SureWest, (the "First Merger") and following consummation of the First Merger, SureWest will merge with and into Merger Sub II, and Merger Sub II shall be the surviving corporation.

Pursuant to the terms of the Merger Agreement our shareholders may elect to exchange each share of SureWest Common Stock for either $23.00 in cash (without interest) or shares of Consolidated Common Stock having an equivalent value based on average trading prices for the 20-day period ending two days before the closing of the acquisition, subject to a collar so that there will be a maximum exchange ratio of 1.40565 shares of Consolidated Common Stock for each share of SureWest Common Stock and a minimum of 1.03896 shares of Consolidated Common Stock for each share of SureWest Common Stock. Overall elections are subject to proration so that 50% of the SureWest shares will be exchanged for cash and 50% for stock. The results of applying the collar and proration provisions are subject to adjustment to ensure the transaction will be treated as a tax-free reorganization for federal income tax purposes. Shares of SureWest with respect to which no election is timely made will be converted into the right to receive the cash consideration or the Consolidated Common Stock, as determined in accordance with the proration described in the Merger Agreement.

The completion of this transaction is subject to customary closing conditions, including the receipt of certain regulatory approvals and approval by our shareholders and the stockholders of Consolidated. The Merger Agreement contains certain termination rights for SureWest and Consolidated. The Merger Agreement stipulates that in the event of a termination of the Merger Agreement under specified circumstances, we would be required to pay Consolidated a fee of $14,675.

In connection with entering into the Merger Agreement with Consolidated, we incurred transaction fees of $3,292 during the quarter ended March 31, 2012.

11. COMMITMENTS AND CONTINGENCIES

The Company, our Board of Directors and Consolidated are named as defendants in six putative shareholder class action lawsuits challenging the proposed Merger. Five shareholder actions were filed in the Superior Court of California, Placer County, and one shareholder action was filed in the United States District Court for the Eastern District of California. The actions are called *Needles v. SureWest Communications, et al.*, filed February 17, 2012, Case No. SCV0030665, *Errecart v. Oldham, et al.*, filed February 24, 2012, Case No. SCV0030703, *Springer v. SureWest Communications, et al.*, filed March 9, 2012, Case No. SCV0030669, *Aievoli v. Oldham, et al.*, filed March 15, 2012, Case No. SCV0030671 and *Waterbury v. SureWest Communications, et al.*, filed March 26, 2012, Case No. SCV0030854, and the federal action is called *Broering v. Oldham, et al.*, filed April 18, 2012, Case No. 212-CV-01025-JAM-EFB. The actions generally allege, among other things, that each member of our Board of Directors breached fiduciary duties to the Company and its shareholders by authorizing the sale of the Company to Consolidated for consideration that is unfair to the our shareholders and agreeing to terms that unduly restrict other bidders from making a competing offer. The complaints also allege that Consolidated and the Company aided and abetted the breaches of fiduciary duties allegedly committed by the members of our Board of Directors. The *Broering* complaint also alleges, among other things, that the joint proxy statement/prospectus filed with the SEC on March 28, 2012 does not make sufficient disclosures regarding the Merger, that our Board of Directors should have appointed an independent committee to negotiate the transaction and that we should have gone back to another bidder to create a competitive bid process. The lawsuits seek equitable relief, including an order to prevent the defendants from consummating the Merger on the agreed-upon terms and/or an award of unspecified money damages. We believe that these claims are without merit. On March 14, 2012, the Placer County Superior Court entered an order consolidating the *Needles*, *Errecart* and *Springer* actions into a single action under the caption *In re SureWest Communications Shareholder Litigation*, Case No. SCV-0030655. Under the terms of this order, all cases subsequently filed in the Superior Court for the State of California, County of Placer, that relate to the same subject matter and involve similar questions of law or fact are to be consolidated with these cases as well. Any party objecting to such consolidation must file its objection within ten days of receiving a copy of the order. Attorneys for the plaintiffs in *Aievoli* and *Waterbury* received copies of the order on or before March 29, 2012 and have not filed any objection. On April 10, 2012, the plaintiff in *Waterbury* filed a request for voluntary dismissal of her complaint without prejudice.

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 and continued expansion of the telecommunications network, 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 2011 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 three months ended March 31, 2012 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.

Significant Recent Development

On February 5, 2012, SureWest Communications entered into an Agreement and Plan of Merger ("the Merger Agreement") by and among SureWest, Consolidated Communications Holdings, Inc., a Delaware corporation, ("Consolidated"), WH Acquisition Corp., a California corporation and wholly owned subsidiary of Consolidated ("Merger Sub I") and WH Acquisition II Corp., a California corporation and wholly owned subsidiary of Consolidated ("Merger Sub II"), pursuant to which Merger Sub I will merge with and into SureWest, (the "First Merger") and following consummation of the First Merger, SureWest will merge with and into Merger Sub II, and Merger Sub II shall be the surviving corporation (the "Second Merger" and, together with the First Merger, the "Mergers").

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 80% of our consolidated operating revenues, primarily from subscriptions to our data, video and voice services ("broadband services") and business services during the quarter ended March 31, 2012. We market our broadband services to residential and business customers, either individually or as part of a bundled package. As of March 31, 2012, our broadband services served approximately 106,800 residential subscribers, of which 84% subscribed to two or more of our broadband services, including 45% that subscribed to all three of our broadband services ("triple play"). As of March 31, 2012, we had approximately 8,400 business customers. Products and features including Advanced Digital TV ("ADTV"), faster data speeds, increased high definition ("HD") channels, home networking and Internet security software create 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 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 March 31, 2012, approximately 65% and 32% of our data customers subscribed to speeds of 5 Mbps and 15 Mbps or greater, respectively. In the Sacramento region, approximately 41% of our data customers subscribe to plans with speeds at or higher than 15 Mbps. As of March 31, 2012, approximately 31% 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 ADTV, powered by Microsoft® Mediaroom. Depending on the service selected and subject to geographic market availability, our digital video service subscribers have access to over 345 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"), digital video recorders ("DVR") and/or a Whole Home DVR. As a result of the launch of a Whole Home DVR in the Kansas City area on March 29, 2012, our digital video subscribers in both regions have 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. As of March 31, 2012, approximately 22% 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 March 31, 2012, 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 23% as of March 31, 2012.

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 398 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 at faster speeds.

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. We are experiencing strong competitive pressure for small business customers; however the market for medium and large business customers remains stable. Business service revenues now represent 62% of the Telecom segment total operating revenues.

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. 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.

Telecom segment revenues continue to decrease as a percentage of our consolidated operating revenues. During the quarter ended March 31, 2012, the Telecom segment generated 20% of our consolidated revenues, a decrease from 25% compared to the same period in 2011. The decline in revenues was 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 were impacted by scheduled reductions for certain regulatory support subsidies. The scheduled declines of regulatory support subsidies began in 2006 and are now fully phased out. We anticipate the recent declines in Telecom revenues to flatten as the scheduled phase out of certain Telecom support mechanisms have been 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 ended March 31, 2012 and 2011.

Financial Data

	Quarter Ended March 31,			
	2012	2011	$ Change	% Change
Operating revenues [1]				
Broadband	$ 49,987	$ 45,379	$ 4,608	10 %
Telecom	12,771	15,176	(2,405)	(16)
Operating revenues	62,758	60,555	2,203	4
Income (loss) from operations				
Broadband	(4,765)	(3,486)	(1,279)	(37)
Telecom	2,571	5,474	(2,903)	(53)
Income from operations	(2,194)	1,988	(4,182)	(210)
Net income (loss)				
Broadband	(5,022)	(4,405)	(617)	(14)
Telecom	1,108	2,761	(1,653)	(60)
Net income	(3,914)	(1,644)	(2,270)	(138)
Net cash provided by operating activities	15,490	19,372	(3,882)	(20)
Adjusted EBITDA [2]				
Broadband	11,646	10,333	1,313	13
Telecom	7,805	9,388	(1,583)	(17)
Adjusted EBITDA	19,451	19,721	(270)	(1)
Free cash flow [2]				
Broadband	(6,312)	(1,291)	(5,021)	(389)
Telecom	2,354	4,144	(1,790)	(43)
Corporate	(110)	(174)	64	37
Free cash flow	(4,068)	2,679	(6,747)	(252)
Adjusted free cash flow [2]				
Broadband	(3,250)	(278)	(2,972)	(1,069)
Telecom	2,828	4,546	(1,718)	(38)
Corporate	(110)	(174)	64	37
Adjusted free cash flow	(532)	4,094	(4,626)	(113)

(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.

Select Operating Metrics

	As of March 31,			
	2012	2011	Change	% Change
Broadband				
Total residential subscribers [(1)]	106,800	104,900	1,900	2 %
Broadband residential revenue-generating units [(2)]	245,000	239,000	6,000	3
Data	102,700	100,300	2,400	2
Video	66,700	63,100	3,600	6
Voice	75,600	75,600	-	0
Total business customers [(3)]	8,400	7,800	600	8
Telecom				
Voice revenue-generating units [(4)]	21,700	27,300	(5,600)	(21)
Total business customers [(3)]	7,500	7,800	(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

Operating Revenues

Operating revenues in the Broadband segment increased $4,608 during the quarter ended March 31, 2012 compared to the same period in 2011. The increase in Broadband operating revenues was attributed to the continued growth in residential and business services. Broadband residential revenues increased $2,750 during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of a 3% increase in RGUs and higher pricing for video and data services.

Broadband business revenues increased $2,041 during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of an 8% increase in business customers as of March 31, 2012. 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. Wireless carrier backhaul revenue increased $476 during the quarter ended March 31, 2012 compared to the same period in 2011. 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.

Operating revenues in the Telecom segment decreased $2,405 during the quarter ended March 31, 2012 compared to the same period in 2011. Residential services decreased $773 during the quarter ended March 31, 2012 compared to the same period in 2011 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 March 31, 2012 compared to 2011. Business revenues decreased $462 during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of a 4% decline in business customers. Access revenues decreased $1,153 during the quarter ended March 31, 2012 compared to the same period in 2011. We did not receive an interim draw during the quarter ended March 31, 2012 due to the completion of the phase-down in the support we received from the California High Cost Fund ("CHCF"). As a result, access revenues decreased $510 during the current year quarter compared to the same period in 2011. In addition, interstate common line ("CL") revenue decreased $499 as a result of CL pool settlements recognized during the current year period. 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 income.

Operating Expenses

Consolidated operating expenses, excluding depreciation and amortization, increased $6,214 during the quarter ended March 31, 2012 compared to the same period in 2011. In connection with entering into the Merger Agreement with Consolidated, as discussed above, we incurred transaction fees of $3,292 during the current year period. These costs were offset in part by severance costs of $888, which included share-based compensation expense of $647, incurred as a result of the retirement of an executive officer during the quarter ended March 31, 2011.

Costs associated with our defined benefit pension plan ("Pension Plan") also increased due to a decline in the discount rate used to determine net periodic pension cost. The actual rate of return on our Pension Plan assets has also been lower than estimated in recent years. As a result of an increase in costs related to the Pension Plan, consolidated operating expenses increased $738 during the quarter ended March 31, 2012 compared to the same period in 2011. See Note 6 for more information on the Pension Plan.

Cost of services and products expense increased $2,462 during the quarter ended March 31, 2012 compared to the same period in 2011. 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.

Customer operations and selling expense increased $1,180 during the quarter ended March 31, 2012 compared to the same period in 2011. Sales and advertising costs increased as a result of new advertising campaigns implemented during the quarter ended March 31, 2012. Labor costs also increased due to the increase in pension costs and an increase in sales force related to the growth in the Kansas City market.

General and administrative expenses increased $2,572 during the quarter ended March 31, 2012 compared to the same period in 2011 primarily as a result of the transaction fees of $3,292 incurred as a result of the Merger Agreement with Consolidated. However, these costs were offset in part by the severance costs of $888 for a retiring officer during the quarter ended March 31, 2011.

Our consolidated depreciation and amortization expense increased $171 during the quarter ended March 31, 2012 compared to the same period in 2011 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 $4,182 during the quarter ended March 31, 2012 compared to the same period in 2011. As described above, income from operations decreased primarily as a result of the transaction fees incurred related to the Merger Agreement with Consolidated and an increase in costs associated with our Pension Plan. Adjusted EBITDA, which excludes the transaction fees and pension costs, decreased $270 during the quarter ended March 31, 2012 compared to the same period in 2011.

Free Cash Flow and Adjusted Free Cash Flow

Free cash flow decreased $6,747 during the quarter ended March 31, 2012 compared to the same period in 2011. The decrease was due to additional capital expenditures related to the expansion of our fiber network as well as the transaction fees associated with the Merger Agreement with Consolidated during the current year period. In 2012, we have planned additional capital investments for network expansion which will include the addition of 11,000 fiber marketable homes in the Kansas City area and the upgrade of 5,000 copper homes within the telephone service area of the Incumbent Local Exchange Carrier ("ILEC") so that they would be video service capable. As of March 31, 2012, we added 1,800 of the planned fiber homes in the Kansas City area and upgraded 1,050 of the planned homes in the ILEC territory.

Adjusted free cash flow, which excludes the capital expenditures for network expansion, decreased $4,626 during the quarter ended March 31, 2012 compared to the same period in 2011. The decrease was due to the transaction fees associated with the Merger Agreement and additional capital expenditures for success-based residential projects during the current year period. We expect capital expenditures and associated free cash flows 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.

Reclassifications

Certain amounts in our 2011 condensed consolidated financial statements have been reclassified to conform to the presentation of our 2012 condensed consolidated financial statements. Operating revenues in the Broadband segment have been reclassified for a change during the fourth quarter of 2011 in the classification of promotional discounts between residential voice, video and data revenue. Prior period revenues have been reclassified to conform to the current year presentation.

Segment Results of Operations

<u>Broadband</u>

	Quarter Ended March 31,			
	2012	2011	$ Change	% Change
Data	$ 13,665	$ 12,184	$ 1,481	12 %
Video	14,549	13,312	1,237	9
Voice	6,367	6,335	32	1
Total residential revenues	34,581	31,831	2,750	9
Business	14,655	12,614	2,041	16
Access	485	556	(71)	(13)
Other	266	378	(112)	(30)
Total operating revenues from external customers	49,987	45,379	4,608	10
Intersegment revenues	191	160	31	19
Operating expenses				
Cost of services and products(1)	28,907	26,323	2,584	10
Customer operations and selling	5,843	5,051	792	16
General and administrative	7,421	4,963	2,458	50
Depreciation and amortization	12,772	12,688	84	1
Loss from operations	(4,765)	(3,486)	(1,279)	(37)
Net loss	(5,022)	(4,405)	(617)	(14)
Adjusted EBITDA(2)	11,646	10,333	1,313	13
Free cash flow(2)	(6,312)	(1,291)	(5,021)	(389)
Adjusted free cash flow(2)	(3,250)	(278)	(2,972)	(1,069)

(1) Exclusive of depreciation and amortization.

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

Broadband Segment Overview

Adjusted EBITDA for the Broadband segment continued to improve during the quarter ended March 31, 2012 compared to the same period in 2011 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 create new long-term revenue opportunities as consumer behavior and technology evolves. We continue to successfully migrate Telecom customers to our Broadband VoIP phone service product mitigating the loss of Telecom voice RGUs. New products and features like ADTV, increased Internet speeds, additional HD channels, home networking and the recently deployed Whole Home DVR in our Kansas City market have 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 also contributed to the increase in adjusted EBITDA during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of an increase in wireless carrier backhaul and an 8% 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.

Broadband Segment Operating Revenues

Residential Revenues

Broadband residential revenues increased $2,750 during the quarter ended March 31, 2012 compared to the same period in 2011. The increase in residential revenues was due in part to the 3% growth in Broadband residential RGUs as of March 31, 2012 compared to 2011. Broadband residential revenues also increased as a result of higher pricing for video and data services implemented in 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 success of our ADTV product in our Sacramento market has resulted in higher take rates for our triple-play services as a bundled package. Our enhanced hybrid fiber coaxial ("HFC") network and the continued expansion of the fiber network in the Kansas City Market enables us to offer our customers faster data speeds and upgraded video services such as additional HD channels and the recently launched Whole Home DVR. 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 through the continued expansion of our network in the 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 our data service in both the Sacramento and Kansas City markets can support the rising demands for data usage and wireless devices in the home as well as 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 $1,481 during the quarter ended March 31, 2012 compared to the same period in 2011 primarily as a result of a 2% increase in data RGUs and a 9% 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. 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. As a result of the launch of a Whole Home DVR in the Kansas City area on March 29, 2012, our digital video subscribers in both regions now have access to these enhanced features and services. 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 354 and 346 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 March 31, 2012, our customers had access to 86 and 80 HD channels in our California and Kansas City markets, respectively.

Residential video revenues increased $1,237 during the quarter ended March 31, 2012 compared to the same period in 2011. 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, we continue to expand our fiber network in the Kansas City market and enhanced our copper network in the Sacramento region allowing us to upgrade homes within the ILEC territory to be video service capable and offer access to our ADTV service. As of March 31, 2012, we completed upgrades to 1,050 homes on the copper network and added 200 marketable homes to our fiber network in the Sacramento region from new home construction. In the Kansas City area, we have passed 1,800 marketable homes of the 11,000 additional fiber homes planned for 2012.

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 2% as of March 31, 2012 compared to 2011. As of March 31, 2012, approximately 19% of the homes in the 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 increased $32 during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of a decline in promotional discounts offered during the current year quarter.

Business Revenues

We provide a variety of business communication 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 $2,041 during the quarter ended March 31, 2012 compared to the same period in 2011 due primarily to an 8% increase in business customers during the same periods. ARPU also increased 8% as of March 31, 2012 compared to the same period in 2011, primarily due to an increase in wireless backhaul services.

Wireless backhaul revenue increased $476 during the quarter ended March 31, 2012 compared to the same period in 2011. 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 decreased $71 during the quarter ended March 31, 2012 compared to the same period in 2011. The decrease was mostly attributable to a decline in carrier access traffic compared to the same period in 2011.

Broadband Segment Operating Expenses

Total operating expenses in the Broadband segment, excluding depreciation and amortization, increased $5,834 during the quarter ended March 31, 2012 compared to the same period in 2011. The increase during the quarter ended March 31, 2012 was due in part to the transaction fees of $2,227 incurred as a result of the Merger Agreement with Consolidated and increased costs related to the Pension Plan of $344, as described in the Consolidated Overview section above.

Cost of services and products (exclusive of depreciation and amortization) increased $2,584 during the quarter ended March 31, 2012 compared to the same period in 2011. 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 local retransmission costs. Video programming fees are expected to continue to increase throughout 2012.

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 and higher costs for off-network carrier transport services. 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. 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 $792 during the quarter ended March 31, 2012 compared to the same period in 2011. Sales and advertising costs increased as a result of the new advertising campaign implemented during the quarter ended March 31, 2012, which included radio and television advertising and promotional materials.

General and administrative expense increased $2,458 during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of the transaction fees of $2,227 related to the pending Merger Agreement with Consolidated.

Depreciation and amortization expense increased $84 during the quarter ended March 31, 2012 compared to the same period in 2011. Depreciation and amortization expense continues to increase due primarily to the continued expansion and enhancement of the broadband network and success-based capital projects.

Telecom

	Quarter Ended March 31,			
	2012	2011	$ Change	% Chang
Business	$ 7,932	$ 8,394	$ (462)	
Residential	2,819	3,592	(773)	(
Access	1,901	3,054	(1,153)	(
Other	119	136	(17)	(
Total operating revenues from external customers	12,771	15,176	(2,405)	(
Intersegment revenues	5,484	5,296	188	
Operating expenses				
Cost of services and products[1]	5,867	5,752	115	
Customer operations and selling	2,820	2,448	372	
General and administrative	3,823	3,711	112	
Depreciation and amortization	3,174	3,087	87	
Income from operations	2,571	5,474	(2,903)	(
Net income	1,108	2,761	(1,653)	(
Adjusted EBITDA[2]	7,805	9,388	(1,583)	(
Free cash flow[2]	2,354	4,144	(1,790)	(
Adjusted free cash flow[2]	2,828	4,546	(1,718)	(

(1) Exclusive of depreciation and amortization.

(2) A non-GAAP measure. See the Non-GAAP Measures section below for additional information and reconciliation to the m 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. However, we anticipate Telecom revenue declines to slow over the next several years as access line losses ease and wholesale revenues increase. Revenues earned by the Telecom segment through a wholesale access agreement with the Broadband segment increased $300 during the quarter ended March 31, 2012 compared to the same period in 2011. 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 73% of total Telecom revenues at March 31, 2012 compared to 67% in the same period in 2011. The Telecom segment continues to contribute the majority of our consolidated net income and adjusted free cash flow.

Over the past few years, the Telecom segment has been transitioning from the traditional revenue sources of residential voice, access services and subsidized revenues to more diversified sources including business and wholesale revenues. This diversification as well as the Telecom segment's reduced reliance on subsidy revenues has minimized the risk that future changes in regulatory and policy rulings may have on our free cash flows.

Telecom Segment Operating Revenues

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 $462 during the quarter ended March 31, 2012 compared to the same period in 2011. 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.

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 $773 during the quarter ended March 31, 2012 compared to the same period in 2011 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 March 31, 2012 compared to the same period in 2011. 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 March 31, 2012, 45% of the decline in Telecom voice RGUs in 2012 was due to customers who have transferred to SureWest Broadband's VoIP 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.

Access Revenues

Access revenues, which include interstate and intrastate switched access revenue, interstate CL revenue and support payments from the CHCF, decreased $1,153 during the quarter ended March 31, 2012 compared to the same period in 2011. As a result of the completion of the phase-down in the amount we receive from the CHCF, we did not receive an interim draw during the quarter ended March 31, 2012 which resulted in a decrease to access revenues of $510 during the quarter ended March 31, 2012 compared to the same period in 2011. Interstate CL revenue also decreased $499 as a result of CL pool settlements recognized during the current year period. 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 $300 during the quarter ended March 31, 2012 compared to the same period in 2011 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. The increase in wholesale access and DSL intersegment revenue was reduced in part by a decline in intersegment long distance revenue.

Telecom Segment Operating Expenses

Total operating expenses for the Telecom segment, excluding depreciation and amortization, increased $599 during the quarter ended March 31, 2012 compared to the same period in 2011. As described in the Consolidated Overview section above, the increase in operating expenses was due in part to the transaction fees of $1,065 incurred as a result of the pending Merger Agreement with Consolidated and the increase in costs related to our Pension Plan of $394 during the quarter ended March 31, 2012.

Cost of services and products (exclusive of depreciation and amortization) increased $115 during the quarter ended March 31, 2012 compared to the same period in 2011as a result of increased labor costs for the continued upgrade of copper homes in the ILEC territory and the increase in pension costs. 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 $372 during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of the increase in pension costs and an increase in advertising related to a new residential advertising campaign in the current year.

General and administrative expense increased $112 during the quarter ended March 31, 2012 compared to the same period in 2011 as a result of $1,065 in transaction costs related to the pending Merger Agreement with Consolidated. However, the increase in the current year period was offset in part by severance costs including share-based compensation expense incurred for a retiring officer during the quarter ended March 31, 2011.

Depreciation and amortization expense increased $87 during the quarter ended March 31, 2012 compared to the same period in 2011. 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 the National Exchange Carrier Association ("NECA"); and
- support payments from federal or state programs.

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 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 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.

The FCC requires SureWest Telephone to prepare and submit periodic cost separation studies related to certain NECA CL accounts receivable balances. As a result of the cost separation filings, SureWest Telephone may change its estimates for certain NECA CL accounts receivable balances related to the prior year monitoring period. During the quarter ended March 31, 2012, this change in estimate decreased our consolidated revenues and increased our loss from operations by $348 and increased our net loss by $213 ($0.02 per share), respectively. We did not record any significant changes in estimates related to prior year monitoring periods during the quarter ended March 31, 2011.

In a 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. The rules became effective November 20, 2011 and the Company is in compliance. However, several challenges to the rules have been filed with the U.S. Court of Appeals. We will continue to monitor this matter in future periods.

In 2011, the FCC adopted an Order ("the Order") to reform the Universal Service Fund ("USF") and Intercarrier Compensation ("ICC") systems. The Order, which became effective December 29, 2011, establishes the Connect America Fund ("CAF") to replace support revenues provided by the current USF and redirects support from voice services to broadband services. The Order may significantly impact the amount of support revenue we receive from USF/CAF and ICC, beginning in 2012. In 2011, we received approximately $5,600 in USF support revenues. Our USF/CAF support in 2012 will be reduced approximately $700 primarily due a provision in the Order that limits corporate operations expense. The FCC has sought additional input on a number of related issues not resolved in the Order, and the related proceeding will review additional USF/CAF support changes for study areas that substantially overlap with unsubsidized facilities-based terrestrial competitors. We have significant overlap with unsubsidized facilities-based competitors and it is anticipated that our USF/CAF support revenue may be reduced further in subsequent years.

The Order adopts a bill-and-keep system as the uniform, national methodology for all ICC traffic exchanged between carriers. ICC reform is effective on July 1, 2012 transitioning our terminating switched access rates to bill-and-keep over a nine-year period. We anticipate reduced switched access revenues of approximately $400, $800, and $400 in 2012, 2013 and 2014, respectively. The impact to switched access revenues in 2015 through 2017 will be minimal under the plan with remaining terminating switched access revenue phasing down to zero by July 1, 2020. The Order adopts a recovery mechanism that allows us to recover reduced ICC revenues, up to a defined baseline amount, from limited increases in end user rates and the CAF. A number of petitions for reconsiderations and court appeals have been filed seeking changes or to overturn specific provisions in the Order and the likelihood of their success cannot be predicted. The Order may be modified as a result of the petitions for reconsideration or the court could vacate, set aside, modify, and/or enjoin and remand to the FCC such relief as it deems just and proper. At this time, the Order and all requirements are in effect until the FCC or the appeals court decides otherwise.

In addition, the Order seeks further comments on a wide range of issues including originating access levels, the 11.25% interstate rate of return, the elimination of transitional recovery mechanisms and IP-to-IP interconnection. Comments related to the Order were filed during the quarter ended March 31, 2012. Further regulatory actions on these issues may have a material impact on our consolidated financial position and results of operations; however the impact cannot be determined at this time.

California Public Utility Commission ("CPUC") Matters

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, (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. 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. Subsequently, the CPUC issued a ruling temporarily deferring the proceeding. The status on when the CPUC may open this proceeding is unclear and on hold at this time. The CPUC's actions in this and future proceedings could lead to new rules and an increase in government regulation. The Company will continue to monitor this matter.

In September 2007, the CPUC issued Decision 07-09-002 which provided for SureWest Telephone to phase-down its $11,500 interim annual California High Cost Fund draw ("interim draw") by $2,040 over a five-year period, from 2007 to 2011. As a result of the completion of the phase-down, we did not receive an interim draw during the quarter ended March 31, 2012 which resulted in a decrease to access revenues of $510 during the quarter ended March 31, 2012 compared to the same period in 2011.

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 decreased $2,203 during the quarter ended March 31, 2012 compared to the same period in 2011. 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 quarter ended March 31, 2011. A decline in long-term debt outstanding and a reduction in interest rates also contributed to the decrease in interest expense.

We received patronage dividends of $149 and $902 during the quarters ended March 31, 2012 and 2011, respectively. We earned 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. In connection with entering into the Credit Agreement, we are no longer eligible to earn patronage dividends from CoBank.

Income Taxes

Income taxes decreased $60 during the quarter ended March 31, 2012 compared to the same period in 2011. The decreases were due primarily to discrete items related to the reversal of unrecognized tax benefits and state refund received during the current year quarter. The effective federal and state income tax rates were 13.7% and 25.5% for the quarter ended March 31, 2012 and 2011, respectively. The decrease in the effective tax rate in the current year compared to the prior year was due primarily to differences related to the transaction costs incurred in conjunction with the pending merger with Consolidated, as well as the reversal of unrecognized tax benefits and 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) from continuing operations excluding amounts for income taxes; depreciation and amortization; non-cash pension and certain post-retirement benefits; non-cash stock compensation; transaction fees as a result of entering into the Merger Agreement with Consolidated; 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 ended March 31, 2012 and 2011:

	Quarter Ended March 31, 2012		
	Broadband	**Telecom**	**Consolidated**
Net income (loss)	$ (5,022)	$ 1,108	$ (3,914)
Add (subtract):			
Income tax expense (benefit)	(1,989)	1,367	(622)
Other (income) expense, net	2,246	96	2,342
Depreciation and amortization	12,772	3,174	15,946
Non-cash pension and post-retirement expense	496	552	1,048
Non-cash stock compensation expense	916	443	1,359
Transaction fees	2,227	1,065	3,292
Adjusted EBITDA	$ 11,646	$ 7,805	$ 19,451

	Quarter Ended March 31, 2011		
	Broadband	**Telecom**	**Consolidated**
Net income (loss)	$ (4,405)	$ 2,761	$ (1,644)
Add (subtract):			
Income tax expense (benefit)	(2,928)	2,366	(562)
Other (income) expense, net	3,847	347	4,194
Depreciation and amortization	12,688	3,087	15,775
Non-cash pension and post-retirement expense	153	160	313
Non-cash stock compensation expense	978	667	1,645
Adjusted EBITDA	$ 10,333	$ 9,388	$ 19,721

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.

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 ended March 31, 2012 and 2011:

	Quarter Ended March 31, 2012	Quarter Ended March 31, 2011
Net cash provided by operating activities	$ 15,490	$ 19,372
Less: Adjustments for all non-cash items and net changes in operating assets and liabilities	(19,404)	(21,016)
Net income	(3,914)	(1,644)
Add: Depreciation and amortization	15,946	15,775
Less: Capital expenditures	(16,100)	(11,452)
Free cash flow	(4,068)	2,679
Add: Capital expenditures for network expansion	3,536	1,415
Adjusted free cash flow	$ (532)	$ 4,094
Free cash flow by segment:		
Broadband	$ (6,312)	$ (1,291)
Telecom	2,354	4,144
Corporate	(110)	(174)
Free cash flow	$ (4,068)	$ 2,679
Adjusted free cash flow by segment:		
Broadband	$ (3,250)	$ (278)
Telecom	2,828	4,546
Corporate	(110)	(174)
Adjusted free cash flow	$ (532)	$ 4,094

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 the first quarter of 2012 was for capital expenditures. We anticipate continuing to use a substantial portion of our cash flow to fund our capital expenditures and network expansion, make our required minimum funding requirement to the Pension Plan and meet scheduled payments of long-term debt.

The following table summarizes our cash flows:

	Three Months Ended March 31, 2012	2011	$ Change
Cash Flows Provided By (Used In):			
Operating Activities	$ 15,490	$ 19,372	$ (3,882)
Investing Activities	(15,944)	(10,454)	(5,490)
Financing Activities	1,692	1,026	666
Increase in Cash and Cash Equivalents	$ 1,238	$ 9,944	$ (8,706)

Cash Flows Provided By Operating Activities

Net cash provided by operating activities was $15,490 during the three-month period ended March 31, 2012. Adjustments to net loss of $3,914 to arrive at cash provided by operating activities primarily included non-cash charges of (i) depreciation and amortization of $15,946 due to capital investments principally in the Broadband segment and (ii) stock compensation expense of $1,359. In addition, accounts receivable decreased $2,503 related to the timing in the receipt of various receivables during the quarter ended March 31, 2012.

Cash Flows Used In Investing Activities

Net cash used in investing activities was $15,944 during the three-month period ended March 31, 2012 and was primarily related to capital expenditures.

Capital expenditures continue to be our primary recurring investing activity and were $16,100 during the three-month period ended March 31, 2012, an increase of $4,648 compared to the same period in 2011. 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. During 2012, we plan to add an additional 11,000 fiber marketable homes in the Kansas City area and upgrade 5,000 copper homes within the ILEC service territory to be video service capable. As of March 31, 2012, we added 1,800 of the planned fiber homes in the Kansas City area and upgraded 1,050 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 2012 are expected to be $60,000 to $70,000 of which approximately 28% is planned for network expansion and 55% is 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 and the payment of dividends.

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 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.

The Credit Agreement includes (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. All amounts outstanding on the Revolving Loan Facility and the Term Loan B Facility will be due on March 2, 2016.

The Term Loan B Commitment included a delayed draw amount, which allowed for one or more additional advances not to exceed $20,000. The delayed draw was to be used solely for capital expenditures. During the quarter ended March 31, 2012, we determined that we would not utilize our $20,000 delayed draw prior to the end of the Term Loan B Availability Period of September 1, 2012. Accordingly, we cancelled our delayed draw effective March 5, 2012.

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

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.

In November 2011, we entered into a Second Amendment to Credit Agreement ("Amendment") to amend certain terms of the Credit Agreement. The Amendment reduced the quarterly principal payments from $3,750 to $1,875, commencing on December 31, 2011 and on the last day of each quarter thereafter, provided that our Leverage Ratio is less than 2.60:1.0 for the preceding two consecutive fiscal quarters. The Amendment also reduced the applicable London Interbank Offered Rate margin and the bank's base rate margin by 50 basis points per annum commencing in November 2011.

As of March 31, 2012, $202,500 and $5,000 was outstanding under the Term Loan B and Revolving Loan facilities, respectively. We had no short-term borrowings as of March 31, 2012. As of March 31, 2012, we had $29,000 available on the Revolving Loan Facility.

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.

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:

Financial Covenant	Required Ratio Level	Actual Performance at March 31, 2012
Leverage ratio	Not more than 3.00	2.48
Interest coverage ratio	Not less than 3.50	8.93
Consolidated net worth	Not less than $200,000	$284,477

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 March 31, 2012, 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 did not repurchase any shares during the quarters ended March 31, 2012 and 2011.

Sufficiency of Cash Resources

We had cash and cash equivalents at March 31, 2012 of $5,446. As discussed in the Long-term Debt section above, we have additional long-term borrowing capacity of approximately $29,000 available to us through our Revolving Loan 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 in 2012 is expected to be for (i) budgeted capital expenditures of $44,000 to $54,000, (ii) scheduled payments of long-term debt of $5,625, (iii) anticipated interest payments of $5,950, (iv) Pension Plan funding requirement of $7,884, and (v) additional transaction costs of approximately $6,700 related to the merger with Consolidated.

On January 26, 2012, our Board of Directors declared a cash dividend of $0.10 per share payable on March 15, 2012 to shareholders of record at the close of business on February 29, 2012. Accordingly, during the quarter ended March 31, 2012 we paid $1,433 in cash dividends on our common stock. 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 2012 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 2012 budgeted capital expenditures are success based and is partially dependent on our ability to manage our growth and expansion.

Defined Benefit Pension Plan

As required, we contribute to our frozen 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. As of January 1, 2012, the expected long-term rate of return of Plan assets is 7.2%. 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, our future funding requirements for the Pension Plan could increase significantly, which could adversely affect our cash flows from operations.

Our minimum funding requirement for 2012 related to the Pension Plan is expected to be $8,462. As of March 31, 2012, we have contributed $578 to our Pension Plan. 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 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.

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 in the Regulatory Matters section above, an order adopted by the FCC may significantly impact the amount of support revenue we receive from USF/CAF and ICC by up to $7,000 over a nine year period, beginning in 2012. In 2011, we received approximately $5,600 in USF support revenues. Our USF/CAF support in 2012 will be reduced approximately $700 primarily due a provision in the Order that limits corporate operations expense. The order also modifies the methodology used for ICC traffic exchanged between carriers. ICC reform is effective on July 1, 2012 transitioning our terminating switched access rates to bill-and-keep over a nine-year period. We anticipate reduced switched access revenues of approximately $400, $800, and $400 in 2012, 2013 and 2014, respectively. The impact to switched access revenues in 2015 through 2017 will be minimal under the plan with remaining terminating switched access revenue phasing down to zero by July 1, 2020.

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 2011 Annual Report on Form 10-K.

Recent Accounting Pronouncements

Recently Issued Accounting Pronouncements

There was no newly issued accounting guidance during the quarter ended March 31, 2012.

Recently Adopted Accounting Pronouncements

On January 1, 2012 we adopted the Accounting Standards Update ("ASU") on fair value measurements and disclosures. The updated guidance (i) clarifies the application of existing fair value measurement and disclosure requirements and (ii) changes a particular principle or requirement for measuring fair value or disclosing information about fair value measurements. Our adoption of this guidance did not impact our consolidated financial position or results of operations.

On January 1, 2012, we adopted an ASU that amended the presentation of comprehensive income 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. In December 2011, the Financial Accounting Standards Board issued an ASU to indefinitely defer the effective date of the provision pertaining only to the presentation of reclassification adjustments out of accumulated other OCI and reinstated the previous requirements to present reclassification adjustments either on the face of the statement in which OCI is reported or to disclose them in a note to the financial statements. Our adoption of this guidance did not impact our consolidated financial position or results of operations.

Regulatory and Legal Matters

The Company, our Board of Directors and Consolidated are named as defendants in six putative shareholder class action lawsuits challenging the proposed Merger. Five shareholder actions were filed in the Superior Court of California, Placer County, and one shareholder action was filed in the United States District Court for the Eastern District of California. The actions are called *Needles v. SureWest Communications, et al.*, filed February 17, 2012, Case No. SCV0030665, *Errecart v. Oldham, et al.*, filed February 24, 2012, Case No. SCV0030703, *Springer v. SureWest Communications, et al.*, filed March 9, 2012, Case No. SCV0030669, *Aievoli v. Oldham, et al.*, filed March 15, 2012, Case No. SCV0030671 and *Waterbury v. SureWest Communications, et al.*, filed March 26, 2012, Case No. SCV0030854, and the federal action is called *Broering v. Oldham, et al.*, filed April 18, 2012, Case No. 212-CV-01025-JAM-EFB. The actions generally allege, among other things, that each member of our Board of Directors breached fiduciary duties to the Company and its shareholders by authorizing the sale of the Company to Consolidated for consideration that is unfair to the our shareholders and agreeing to terms that unduly restrict other bidders from making a competing offer. The complaints also allege that Consolidated and the Company aided and abetted the breaches of fiduciary duties allegedly committed by the members of our Board of Directors. The *Broering* complaint also alleges, among other things, that the joint proxy statement/prospectus filed with the SEC on March 28, 2012 does not make sufficient disclosures regarding the Merger, that our Board of Directors should have appointed an independent committee to negotiate the transaction and that we should have gone back to another bidder to create a competitive bid process. The lawsuits seek equitable relief, including an order to prevent the defendants from consummating the Merger on the agreed-upon terms and/or an award of unspecified money damages. We believe that these claims are without merit. On March 14, 2012, the Placer County Superior Court entered an order consolidating the *Needles*, *Errecart* and *Springer* actions into a single action under the caption *In re SureWest Communications Shareholder Litigation*, Case No. SCV-0030655. Under the terms of this order, all cases subsequently filed in the Superior Court for the State of California, County of Placer, that relate to the same subject matter and involve similar questions of law or fact are to be consolidated with these cases as well. Any party objecting to such consolidation must file its objection within ten days of receiving a copy of the order. Attorneys for the plaintiffs in *Aievoli* and *Waterbury* received copies of the order on or before March 29, 2012 and have not filed any objection. On April 10, 2012, the plaintiff in *Waterbury* filed a request for voluntary dismissal of her complaint without prejudice.

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 CL 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.

In addition to the litigation described above, 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.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Our 2011 Annual Report on Form 10-K contains certain disclosures about our exposure to market risk for changes in interest rates on our long-term debt obligations. There have been no material changes to the information provided which would require additional disclosures as of the date of this filing.

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

There has been no change in our internal control over financial reporting during the quarter ended March 31, 2012.

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.

PART II –OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

Refer to Notes 9, 10 and 11 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.

Exhibit No.	Description	Method of Filing
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.

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: May 2, 2012

Exhibit 31.1

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: May 2, 2012

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

Exhibit 31.2

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: May 2, 2012

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

Exhibit 32.1

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 March 31, 2012 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: May 2, 2012

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.

Exhibit 32.2

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 March 31, 2012 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: May 2, 2012

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.