BELLSOUTH CORP
Form 10-K
February 24, 2004

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)	
X	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2003**
	OR
____	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from to**

COMMISSION FILE NUMBER 1-8607

BELLSOUTH CORPORATION

A GEORGIA CORPORATION	**I.R.S. EMPLOYER NO. 58-1533433**

1155 Peachtree Street, N.E., Room 15G03, Atlanta, Georgia 30309-3610
Telephone number 404-249-2000

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS	**NAME OF EACH EXCHANGE ON WHICH REGISTERED**
See Attachment.	See Attachment.

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

None.

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes __ No X

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes X No __

At January 31, 2004, 1,831,522,713 shares of Common Stock and Preferred Stock Purchase Rights were outstanding.

At June 30, 2003, the aggregate market value of the voting and non-voting stock held by nonaffiliates was $49,193,148,101.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement dated March 10, 2004, issued in connection with the 2004 annual meeting of shareholders (Part III).

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ATTACHMENT

Title of Each Class	Name of Each Exchange On Which Registered
Common Stock (par value $1 per share) and Preferred Stock Purchase Rights	**New York Stock Exchange**
Debt Securities:	**New York Stock Exchange**
Issued by BellSouth Capital Funding Corporation[a]	
7.12% Debentures due 2097	
7 3/8% Quarterly Interest Bonds due 2039	
Issued by BellSouth Telecommunications, Inc.	
Fifteen Year 5 7/8% Debentures, due January 15, 2009	
Forty Year 6 3/4% Debentures, due October 15, 2033	
Forty Year 7 5/8% Debentures, due May 15, 2035	
Thirty Year 7% Debentures, due October 1, 2025	
Fifty Year 5.85% Debentures, due November 15, 2045	
One Hundred Year 7% Debentures, due December 1, 2095	
Twenty Year 6.30% Amortizing Debentures, due December 15, 2015	
Principal Amount of One Hundred Year 6.65% Zero-To-Full Debentures, due December 15, 2095	
Twelve Year 7% Notes, due February 1, 2005	
Eleven Year 6 3/8% Notes, due June 15, 2004	
Ten Year 6 1/2% Notes, due June 15, 2005	
Thirty Year 6 3/8% Debentures, due June 1, 2028	

(a) Subsequently merged with and into BellSouth Corporation.

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* All or a portion of the referenced sections have been included in BellSouth Corporation s definitive proxy statement dated March 10, 2004 and incorporated herein by reference.

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PART I

Cautionary Language Concerning Forward-Looking Statements

In addition to historical information, this document contains forward-looking statements regarding events, financial trends and critical accounting policies that may affect our future operating results, financial position and cash flows. These statements are based on our assumptions and estimates and are subject to risks and uncertainties. For these statements, we claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

There are possible developments that could cause our actual results to differ materially from those forecast or implied in the forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which are current only as of the date of this filing. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

While the below list of cautionary statements is not exhaustive, some factors, in addition to those contained throughout this document, that could affect future operating results, financial position and cash flows and could cause actual results to differ materially from those expressed in the forward-looking statements are:

- a change in economic conditions in domestic or international markets where we operate or have material investments which could affect demand for our services;
- changes in US or foreign laws or regulations, or in their interpretations, which could result in the loss, or reduction in value, of our licenses, concessions or markets, or in an increase in competition, compliance costs or capital expenditures;
- continued pressures on the telecommunications industry from a financial, competitive and regulatory perspective;
- the intensity of competitive activity and its resulting impact on pricing strategies and new product offerings;
- changes in the federal and state regulations governing the terms on which we offer wholesale services to our competitors;
- continued successful penetration of the interLATA long distance market;
- the unwillingness of banks or other lenders to lend to our international operations or to restructure existing debt, particularly in Latin America;
- consolidation in the wireline and wireless industries in which we operate;
- higher than anticipated start-up costs or significant up-front investments associated with new business initiatives;
- the outcome of pending litigation;
- unanticipated higher capital spending from, or delays in, the deployment of new technologies;
- continued deterioration in foreign currencies relative to the US Dollar in foreign countries in which we operate, particularly in Latin America;
- the impact of terrorist attacks on our business;
- the impact and the success of the wireless joint venture with SBC Communications, Inc., known as Cingular Wireless, including marketing and product development efforts, technological changes, financial capacity and closing and integration of the pending acquisition of AT&T Wireless Services, Inc.; and
- Cingular Wireless failure to realize, in the amounts and within the timeframe contemplated, the capital and expense synergies and other financial benefits expected from its proposed acquisition of AT&T Wireless as a result of technical, logistical, regulatory and other factors.

Business

OVERVIEW

In this document, BellSouth Corporation and its subsidiaries are referred to as we or BellSouth.

We are a Fortune 100 communications services company headquartered in Atlanta, Georgia. We and our affiliates serve over 45 million local, long distance, Internet and wireless customers in the United States and 13 other countries. We provide an array of voice, broadband data and e-commerce solutions to business customers. In the residential market, we offer digital subscriber line (DSL) high-speed Internet access, advanced voice features and other services. We also provide online and directory advertising services, including BellSouth® Real Pages℠.com. We own approximately 40 percent of Cingular Wireless (Cingular), the nation s second largest wireless company in terms of customers, which provides wireless voice and data services. With one of the largest shareholder bases in America, we have assets of $50 billion and employ almost 76,000 individuals. Our principal executive offices are located at 1155 Peachtree Street, N.E., Atlanta, Georgia 30309-3610 (telephone number 404-249-2000). We are incorporated under the laws of the State of Georgia.

We were incorporated and became a publicly traded company in December 1983 as a result of the breakup of the Bell System. The breakup also created several other local exchange companies, which are referred to as Baby Bells in this document. From January 1984 through February 1996, the services that we and the other Baby Bells could offer were governed by the terms of the 1982 settlement of the antitrust suit that led to the breakup of the Bell System. Under the terms of that settlement, we could provide local exchange, network access, information access (such as data transport) and long distance telecommunications services within assigned geographical territories, termed Local Access and Transport Areas (LATAs). Although prohibited from providing wireline service between LATAs, we were allowed to provide network access services that linked our customers telephone or other equipment in one of our LATAs to the transmission facilities of other, nonaffiliated carriers. This resulted in the availability of telecommunications services between LATAs.

The Telecommunications Act of 1996 superseded the governing terms of the 1982 settlement and provided for the development of competition in local telecommunications markets and the conditions under which the Baby Bells can provide interLATA wireline telecommunications and other services. Our ability to offer the services previously proscribed to us by the terms of the 1982 settlement, including the provision of interLATA long distance services, is subject to compliance with the Telecommunications Act of 1996 and the regulations of the Federal Communications Commission (FCC). During 2002, we received FCC permission to provide interLATA long distance services in each of the nine southeastern states that we serve.

We are subject to increasing competition in all areas of our business. Regulatory, legislative and judicial actions and technological developments have expanded the types of available services and products and the number of companies that may offer them. Increasingly, this competition is from large companies as well as small, specialized companies and joint ventures that have substantial capital, technological and marketing resources and are subject to fewer regulatory constraints.

We have four operating segments that are the focus of our business:

- Communications Group;
- Domestic Wireless;
- Latin America Group; and
- Advertising and Publishing Group.

See Note O to our consolidated financial statements for financial data on each of our segments.

Communications Group

OVERVIEW

We are the predominant telecommunications service provider in the southeastern US, serving substantial portions of the population within Alabama, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina and Tennessee. BellSouth Telecommunications, Inc. (BST), a wholly owned subsidiary, provides wireline communications services, including local exchange, network access, intraLATA long distance services and Internet services. BellSouth Long Distance (BSLD), our long distance subsidiary, provides intraLATA and interLATA long distance services in our nine southeastern states, wholesale long distance primarily to wireless communications providers, smaller wireline telecommunications providers and unaffiliated long distance providers, and prepaid calling card services through agreements with unaffiliated long distance providers. Communications Group operations generated 81% of our total operating revenues for 2003 and 2002 and 79% for 2001.

While we provide telecommunications service to the majority of the metropolitan areas in our region, there are many localities and sizable geographic areas within the region that are served by nonaffiliated telecommunications carriers. In addition, there is increasing competition within our territory from other telecommunications carriers, long distance carriers, cable television operators, voice over Internet protocol (VoIP) providers and wireless carriers. We have organized our marketing efforts to parallel our major customer bases: consumer, small business, large business, and interconnection services.

Consumer. This unit serves the largest segment of the market within our region, the residential customer. While traditional local and long distance telephone service remains the core of this market, customer demands are rapidly broadening to include an expanded range of services, from convenience features such as caller ID, call forwarding and voice mail, to dial-up access to the Internet, high-speed DSL and video services. During 2003, the consumer unit represented 43% of Communications Group revenues.

Small Business. This unit focuses on providing, in addition to traditional local and long distance voice services, advanced voice, data, Internet and networking solutions to small and medium-sized businesses. It offers a full selection of standard and customized communications services to this market. During 2003, the small business unit represented 12% of Communications Group revenues.

Large Business. This unit provides a wide range of standard and highly specialized services and products to large and complex business customers. In addition to traditional local and long distance voice services, product and service offerings to these customers include Internet access, private networks, high-speed data equipment and transmission, conferencing and industry specific communications arrangements for industries such as banking, healthcare and manufacturing. During 2003, the large business unit represented 18% of Communications Group revenues.

Interconnection Services. This unit provides interconnection to our network and other related wholesale services to telecommunications carriers for use in providing services to their customers. Interconnection refers to the link between our telecommunications network and the telecommunications network of other telecommunications carriers, such as AT&T, Sprint, MCI (formerly known as WorldCom) and other long distance and competitive local exchange carriers. In addition to interconnection services, we provide services such as voice and data transport services. During 2003, the interconnection services unit represented 24% of Communications Group revenue and generated 48% of our reported data revenues. The unit provides services to both affiliated and nonaffiliated customers in six different carrier markets: wireless service providers, competitive local exchange carriers, competitive switched and special access providers, long distance carriers, information service providers and public payphone service providers.

BUSINESS STRATEGY

Our business strategy is to solidify BellSouth as the leading choice of customers in the southeast for an expanding array of voice, data and Internet services and to meet our customers needs through teaming or wholesale service arrangements with other companies.

We intend to:

optimize our portfolio of retail and wholesale products and services by utilizing marketing approaches targeted to our different customer segments, by providing superior service and by offering flexible packages of voice, data and multimedia applications through improved distribution channels and systems;

become the leading provider of local broadband/Internet Protocol (IP) services in the southeast by deploying new broadband/IP platforms that support both voice and data services as well as applications; and

reduce our cost structure by managing the utilization of existing assets and redirecting spending to focus new investment on high-growth products and services.

BUSINESS OPERATIONS

VOICE SERVICES

Voice services include basic dial-tone telephone service and switching services provided through the regular switched network. In addition, we offer various standard convenience features, such as caller ID, call waiting, call return and 3-way calling on a monthly subscription or for some, on a per-use basis. Additional voice related revenues are derived from charges for inside wire maintenance contracts, voice messaging services, directory assistance and operator services. Voice revenues also include amounts received from the universal service fund for support of high cost areas.

We offer our voice services on a wholesale basis to other competitive local carriers for resale to their customers. Competitors primarily utilize our local network under two methods: resale and, to a greater extent, through the use of unbundled network elements (UNEs). Lines provided on a resale basis include all of the components necessary for a wholesale customer to provide complete service delivery to an end-user. UNEs represent components of our network that wholesale customers may combine with components of their own networks, or with other UNEs purchased from us to allow complete service delivery to an end-user. See Regulatory Environment Federal Regulatory Matters FCC Interconnection Rules for a discussion of UNE pricing.

We provide network access and interconnection services by connecting the equipment and facilities of our customers with the communications networks of long distance carriers, competitive switched and special access providers, and wireless providers, including Cingular. Similarly, we provide access and interconnection services to competitive local exchange carriers so their subscribers can reach ours and vice versa. As a result of access reform, the revenues that we derive from these services have diminished over the past several years. See Regulatory Environment Federal Regulatory Matters Access Charge Reform for a discussion of this matter.

As described above in Business Overview , BellSouth was historically permitted to provide long distance services only within, but not between, certain areas (referred to as LATAs) that were defined at the time of the Bell System divestiture. Legislation was enacted in 1996 that allowed BellSouth, upon approval by the Federal Communications Commission, to provide interLATA services. BellSouth received that approval for all nine states in its region during 2002. We were the first Baby Bell to receive approval for all of its territory.

As a consequence of the long distance approval described above, BellSouth has aggressively entered the interLATA long distance market in its nine state region. BellSouth s entry has addressed both the mass and complex markets. On the mass market side, BellSouth offers a wide array of calling plans to both its residential and business customers. Many of these long distance offers have been packaged with the Company s local, data and wireless offerings so as to present a bundle of services to its customers. These bundles allow customers to purchase services at prices lower than they would have paid if they had bought the underlying services on a stand alone basis. As of December 31, 2003, BellSouth has achieved a long distance market penetration of 28% among its residential local customers and 39% among its mass market business local customers.

Voice services provided approximately 56% of BellSouth s total operating revenues for 2003 and 2002 and 54% for 2001.

BROADBAND AND DATA SERVICES

As use of the Internet grows and as corporate data applications increase in sophistication and scope, the market for broadband and data services is expanding and evolving. BellSouth will continue to expand its capabilities in order to maintain a leadership position in the broadband and data communications market. Investment in service infrastructure is strategically managed to enable delivery of services offering increasing capacity and functionality. In parallel, we continue to use new advances in digital technology to bolster the broadband capabilities of our entire network. The emergence of high-performance broadband and digital infrastructure offers the ability to use these networks for real-time communications including voice and video using various technologies such as softswitches (software-based switching platforms) and voice over Internet protocol (VoIP).

We offer a wide range of data services serving the retail as well as the wholesale markets. Revenues from retail offerings such as FastAccess® (DSL), ISDN, Frame Relay, Lightgate and SmartRing accounted for 51% of total data revenues in 2003 while wholesale offerings accounted for the remaining 49%.

DSL service is an important broadband service for BellSouth. Over 70% of the households in our franchises are qualified to receive DSL from BellSouth, and we ended 2003 with over 1.46 million DSL subscribers. BellSouth participates in the DSL market in two significant ways. We offer DSL transport products to Internet service providers and other carriers, which, in turn, provide information services, such as Internet access, to their end users. We also offer our own retail DSL-based high speed Internet service that we market under the name BellSouth®

FastAccess® DSL.

We continue to deploy new DSL products with the introduction in 2003 of FastAccess® DSL Lite, a new lower speed residential product that offers download speeds up to 256 Kbps as compared to download speeds up to 1.5 Mbps for standard FastAccess®. This new Lite product was designed to reach and convert current dial Internet customers to broadband. We introduced FastAccess® Lite

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at a monthly rate that was $10 less than standard FastAccess®. In 2004, BellSouth expects to begin offering a higher speed version of FastAccess® that will have download speeds of up to 3 Mbps. We expect to be in a strong position to offer a full range of Internet access products, ranging from dial-up access to 3 Mbps services that also include many state of the art features such as Parental Controls and virus scanning.

Through a resale arrangement with Qwest Communications Corporation, we are able to offer data services to meet the needs of sophisticated business purchasers of long distance services. These complex services are offered to enterprise business customers not just in our nine state region, but throughout the United States.

Broadband and data services generated approximately 19% of BellSouth s total operating revenues for 2003 and 2002 and 17% for 2001.

OTHER COMMUNICATIONS GROUP REVENUES

Other Communications Group revenues are comprised primarily of charges for billing and collection services for long distance carriers, enhanced white pages listings, customer late payment fees and customer premises equipment sales and maintenance services. Other revenue also includes charges for permitting our competitors to set up their equipment in our facilities (referred to as collocation). Historically, revenues from local payphone services were included in this category. By the end of 2003, we had ceased offering local payphone services through a separate subsidiary of BST. Due to our gradual phase-out of the business, we do not expect any material financial impact on results of operations with respect to exiting this business. BellSouth also provides wholesale long distance services, primarily to wireless communications providers and smaller wireline telecommunications providers, as well as to unaffiliated long distance providers, and we offer prepaid calling card services through agreements with an unaffiliated long distance provider. Other Communications Group services provided approximately 6% of BellSouth s total operating revenues for 2003 and 8% for 2002 and 2001.

REGULATORY ENVIRONMENT

Our wireline business is regulated by the FCC and state public commissions.

FEDERAL REGULATORY MATTERS

The FCC regulates rates and other aspects of our provision of interstate telecommunications services. In addition, pursuant to the Telecommunications Act of 1996, the FCC has authority to establish policies for pricing and terms of interconnection between local exchange carriers such as BellSouth. Prior to 1996, this activity had been mostly the exclusive jurisdiction of the state regulatory commissions. The states now set the rates and establish terms for interconnection within the policy framework ordered by the FCC. We expect the FCC to continue policies that promote local service competition.

FCC interconnection rules

Under the 1996 Act, the FCC is obliged to consider the extent to which we must make elements of our network available to other providers of local service. The FCC can require access to proprietary network elements only when necessary. For non-proprietary elements, the FCC can order access only when failure to do so will impair the ability of the requesting carrier to provide services.

The FCC issued its most recent set of rules governing the provision of elements with local competitors in August 2003. The order establishing the rules is referred to as the Triennial Review Order. The previous two sets of rules were vacated by the courts. The most recent set of rules generally presume that carriers will be impaired without access to our unbundled switching when the competitor is serving a mass market customer. The new rules also presume that competitors will not be impaired without such access if they are serving medium to large business customers. These presumptions have the effect of requiring us to continue offering the unbundled network platform, or UNE-P, for our competitors to use in serving mass market customers for at least a 27 month transition specified in the rules. The rules make other presumptions about our transport and high capacity loop elements. These presumptions are subject to proceedings that the FCC has delegated to the state commissions. Under the new rules, the states are required to (1) conduct proceedings, all of which are to be completed by July 2, 2004, (2) determine the elements that the carriers subject to the rules will have to provide, and (3) specify the markets in which they will be provided.

The FCC s order establishing the rules has been appealed and is pending before the DC Circuit Court of Appeals. Some carriers, including BellSouth, have challenged the Triennial Review Order as requiring too much unbundling of their networks and delegating authority to the states that should be exercised by the FCC. Other carriers, mostly new entrants since the 1996 Act, have appealed the rules, contending that they provide too little unbundling of our network. State commissions have also challenged the order as being an illegal restriction on their powers. Arguments in the case occurred in late January and we expect a decision during the first half of 2004. While the appeal is pending, we continue to participate in the state proceedings required by the rule.

In addition, we asked the FCC to reconsider certain different portions of its Triennial Review Order related to the regulation of broadband facilities. We asked the FCC to expand the unbundling freedom its Order provides to some broadband facilities. Other parties have sought reconsideration of many other portions of the Order.

If the appeal, reconsideration or state decisions require us to increase the number or scope of elements we must provide, or if the appeal, reconsideration or state decisions allow competitors greater ability to substitute unbundled elements for special access services, or contain other negative features, we could experience a material adverse effect on revenues and results of operation.

Pricing of network elements

The FCC also establishes the pricing policy for elements. The policy currently in effect is TELRIC (an acronym for

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Total Element Long-Run Incremental Cost), which assumes a hypothetical, least cost, most efficient network for purposes of establishing prices for elements. The states have set prices for elements under this policy since 1996.

The FCC has established a proceeding to consider modification of TELRIC. We are participating in that proceeding, pursuant to which the FCC may modify TELRIC to require reflection of the costs of an actual network. However, the final regulations could arbitrarily exclude certain actual costs which could result in an adverse effect on revenues and results of operations.

Price regulation

The FCC regulates interstate prices using a price regulation plan, generally known as a price cap plan. The FCC s price cap plan limits aggregate price changes to the rate of inflation, minus productivity offset, plus or minus other cost changes recognized by the FCC. The productivity factor can vary among services. Interstate prices have been decreasing over the last few years as a result of low inflation in the US economy.

Access charge reform

The FCC has favored access reform, through which the historical subsidy for residential local service contained in network access charges paid by long distance carriers is funded instead by the end-user, by universal service funds, or both. As a result of a May 2000 FCC order implementing access charge reform (referred to as the CALLS order), we have reduced the interstate network access charges paid by long distance carriers and increased interstate subscriber line charges paid by end-users. These rate changes better align our cost recovery with the way in which we incur costs.

We continue to participate in FCC examinations of further access reform. The FCC has undertaken a comprehensive examination of intercarrier compensation the payments among telecommunications carriers resulting from use of their respective interconnecting networks. In general, there are two classes of intercarrier compensation: (1) reciprocal compensation that applies to local calls; and (2) access charges that apply to long distance calls. The objective of the FCC s comprehensive examination is to examine existing rules pertaining to intercarrier compensation and explore alternative forms of intercarrier compensation. This examination could lead to permanent changes in the way carriers compensate one another and in the way carriers receive compensation from their end-user customer. One alternative under consideration is bill and keep , a policy that requires carriers to exchange traffic freely with each other and to recover from end-user customers the costs of transmitting traffic. Either in this proceeding or in a separate proceeding, the FCC will reconsider its methodology and rates for reciprocal compensation. See Reciprocal Compensation below.

There are other aspects of access charges and universal fund contribution requirements that continue to be considered by state and federal commissions that could result in greater expense levels or reduced revenues.

Universal service

Historically, network access charges paid by other carriers were set at levels that subsidized the cost of providing local residential service. The Telecommunications Act of 1996 requires that the FCC identify and remove the historical implicit local service subsidy from network access rates, arrange for a universal service fund to ensure the continuation of service to high-cost, low-income service areas and develop the arrangements for payments into that fund by all carriers. The FCC s universal service order established funding mechanisms for high-cost and low-income service areas. We began contributing to the new funds in 1998 and are recovering our contributions through increased interstate charges to retail end-users.

The FCC s universal service mechanism for non-rural carriers serving high-cost, low-income areas is designed to ensure that customers in those areas receive telephone service at affordable rates. BellSouth is receiving high-cost support for service to residents in Alabama, Kentucky and Mississippi.

The universal service order also established significant discounts to be provided to eligible schools and libraries for all telecommunications services, internal connections and Internet access. Further, it established support for rural health care providers so that they may pay rates comparable to those that urban health care providers pay for similar services. Industry-wide annual costs of the program, estimated at approximately $6 billion, are to be funded out of the universal service fund. Local, long distance and wireless carriers contributions to the education and health care funds are assessed by the fund administrator on the basis of the carriers interstate end-user revenues.

Number portability

In 1996, the FCC ordered certain local number portability requirements for both wireline and wireless carriers. The order required wireline carriers to enable customers remaining in the same location to choose a different wireline carrier while retaining their same telephone number. This wireline requirement was implemented in 1997. Wireless number portability received several extensions, and was implemented in November 2003.

During 1998, the FCC adopted an order that allowed incumbent local exchange carriers to recover over five years their carrier-specific costs of implementing long-term number portability. The 1998 order permitted cost recovery in the form of a surcharge to customers to whom number portability is available.

Current portability capabilities now allow wireline customers to select wireless service and keep their old wireline number. Subject to current technical limitations, wireless customers may switch their wireless number to wireline service. Because the 1998 cost recovery order did not include the costs of implementing wireless number portability, we filed a petition with the FCC to recover approximately $38 million in costs for that implementation. The implementation of wireless number portability could negatively impact our wireline operations, as customers are able to transfer their residential or business telephone number to a wireless telephone, and because the ability to transfer wireless numbers to wireline service is technically limited. The expanded number portability could also increase the rate of Cingular s churn.

Reciprocal compensation

Following the enactment of the 1996 Act, our telephone company subsidiary, BST, and various competitive local exchange carriers entered into interconnection agreements providing for, among other things, the payment of reciprocal compensation for local calls initiated by the customers of one carrier that are completed on the network of the other carrier. These agreements were the subject of litigation before various regulatory commissions. After an FCC ruling in April 2001 prescribing new rates, BellSouth settled its claims with competitors for traffic occurring through mid-June 2001, and entered into agreements that contained the FCC rates for traffic occurring from mid-June 2001 forward. The District of Columbia Circuit Court of Appeals, in the second quarter of 2002, remanded the ruling to the FCC to implement a rate methodology consistent with the Court s opinion. The FCC s previous rules and rates remain in effect while it reconsiders them. A change in the rules or rates could increase our expenses.

Broadband regulation

In the Triennial Review Order, the FCC eliminated the high frequency portion of the loop (HFPL) as a UNE. Competitive local exchange carriers have used the HFPL to provide DSL over the same loop on which the incumbent local exchange carrier provides voice services. This is known as Line Sharing. The FCC grandfathered existing Line Sharing arrangements, and allowed new Line Sharing arrangements to exist for one additional year. The FCC also clarified that packet switching is not a UNE.

BellSouth does not provide FastAccess® (DSL) when an end user obtains voice services from a third party voice provider. The FCC examined this practice in connection with BellSouth s request for long distance approval and determined that we had no obligation to provide FastAccess® (DSL) over a competitive carrier s leased facilities. The public service commissions in Florida, Georgia, Kentucky and Louisiana, however, have each ordered BellSouth to discontinue that practice in their respective states. BellSouth appealed each of these orders. BellSouth also filed a petition with the FCC asking the FCC to find that state commissions are preempted from requiring that BellSouth provide DSL-based services to competitive local exchange carrier UNE voice customers.

The FCC has a pending docket in which it is considering the regulatory classification of broadband service. Specifically, it is looking at whether broadband service should be deemed a regulated telecommunications service or a non-regulated information service.

The FCC and various state public service commissions are considering what rules and regulations should apply to voice over Internet protocol services. We are unable to predict what the outcome will be from these proceedings.

STATE REGULATORY MATTERS

We are subject to regulation of our local and intrastate long distance services by a state authority in each state where we provide intrastate telecommunications services. Such regulation covers prices, services, competition and other issues.

Price regulation

We currently operate under price regulation plans in all states in our wireline territory. Under these plans, the state regulatory commissions or state legislatures have established maximum prices that can be charged for certain telecommunications services. While such plans limit the amount of increases in prices for specific services, they enhance our ability to adjust prices and service options to respond more effectively to changing market conditions and competition. Price regulation also provides an opportunity to benefit more fully from productivity enhancements. The majority of these plans have limitations on raising prices for basic local exchange services during the early years with provisions for inflation-based price increases in later years.

While some plans are not subject to either review or renewal, other plans contain specified termination dates and/or review periods. Upon review or renewal, a regulatory commission could attempt to require substantial modifications to prices and other terms of these plans. During 2003, our plan in Louisiana was renewed. A review of our Kentucky plan is pending. We also expect reviews of our plans in Alabama, Mississippi and North Carolina during 2004.

Beginning in 1996, we operated under a price regulation plan approved by the South Carolina Public Service Commission (PSC) under existing state laws. In April 1999, however, the South Carolina Supreme Court invalidated this price regulation plan. In July 1999, we elected to be regulated under a new state statute, adopted subsequent to the PSC s approval of the earlier plan. The new statute allows telephone companies in South Carolina to operate under price regulation without obtaining approval from the PSC. The election became effective during August 1999. The South Carolina Consumer Advocate petitioned the PSC seeking review of the level of our earnings during the 1996-1998 period when we operated under the subsequently invalidated price regulation plan. The PSC dismissed the petition in November 1999 and issued orders confirming the vote in February and June of 2000. In July 2000, the Consumer Advocate appealed the PSC s dismissal of the petition. In January 2004, the court hearing the appeal affirmed the PSC s decision. An appeal of this decision to the South Carolina Supreme Court is probable. If the Consumer Advocate eventually prevails, the case could be remanded to the PSC, which could, after considering evidence, order refunds to customers in South Carolina, which in the aggregate may be material to the company. At this time, we are unable to predict the outcome of this probable appeal and, therefore, cannot determine the impact, if any, this matter may have on future earnings.

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Other state regulatory matters

In each of our states, we are subject to performance measurement plans that measure our service performance to competitors against certain benchmarks and our own retail performance. When we do not meet the relevant standards, we make payments to the competitors or the State s treasury. In some states, if we continuously fail to meet certain criteria, we also would suspend our marketing and sale of long distance services. We made payments in all states in 2002 and 2003, and likely will make payments in 2004. The plans are reviewed regularly for necessary changes.

COMPETITION

We face significant competition from traditional telecommunications providers. Further, we are increasingly seeing competition from wireless, cable and other providers that have not historically competed with us for telecommunications customers.

TRADITIONAL TELECOMMUNICATION SERVICE PROVIDERS

The state public service commissions with jurisdiction over our services have granted numerous applications to competitive local exchange carriers for authority to offer local telephone service. As a result, substantial competition has developed in the marketplace. We compete for customers based principally on service offerings, price and customer service. Increasing competition has resulted in innovative packaging and services that strive to simplify the customer s experience. Pricing pressures in the market have increased resulting in opportunities for the customer to purchase value based packages and services. Competitive pressures across the board have resulted in an increase in advertising and promotional spending. Competitors, including major carriers, resell our local services, use separate unbundled network elements (UNE) or provide services over their own facilities.

Wholesale UNE prices are based on a forward-looking cost model and the premise of a most efficient, least cost network design. Because the pricing is not based on actual cost, certain costs that exist in today s network are not adequately addressed in the calculations. A competitors use of UNEs and the UNE platform results in lower revenue per access line and has a detrimental impact on our margins as we are not allowed to charge UNE competitors for the actual level of costs to maintain and service the access line. The impact is amplified due to competitors fashioning service bundles that target high valued customers. In addition, revenues from non-UNE sources, such as access to our switches and calling features as well as complementary services such as inside wire maintenance, operator services and in some cases directory assistance, are lost to UNE provisioned lines. As a result of regulated wholesale prices and highly competitive pricing, our competitors have been effective in gaining market share, primarily in metropolitan areas. At December 31, 2003, we had provisioned approximately 2.7 million resale and UNE lines to competing carriers, an increase of 34% since December 31, 2002.

Companies compete with us for long distance services by reselling long distance services obtained at bulk rates from us or from other carriers, or by providing long distance services over their own facilities. In addition, we are increasingly competing for long distance customers with wireless providers that offer a bucket of minutes without differentiating between local and long distance services.

FCC rules require us to offer expanded interconnection for interstate special and switched network access transport. As a result, we must permit competitive carriers to terminate their transmission lines on our facilities in our central office buildings and other locations through collocation arrangements. The effects of the rules are to increase competition for network access transport. Furthermore, long distance carriers are increasingly connecting their lines directly to their customers facilities, bypassing our networks and thereby avoiding network access charges entirely.

Although our competitors vary by state and market, we believe that at December 31, 2003 our most significant local service competitors include AT&T, MCI and Supra and our most significant long distance competitors include AT&T, MCI and Sprint.

BROADBAND SERVICE PROVIDERS

We continue to face intense competition from cable broadband providers who are not subject to the same rigorous regulatory scrutiny for their broadband services. Recent state regulatory rulings requiring BellSouth to provide FastAccess® (DSL) over UNE lines adds costs and complexity to delivery of service that inhibits our efforts to compete with cable on a level playing field.

OTHER TYPES OF COMPETITORS

An increasing number of voice and data communications networks utilizing fiber optic lines have been constructed by communications providers in all major metropolitan areas throughout our wireline service territory. Furthermore, wireless voice and paging services increasingly compete with wireline communications services to provide both voice and data services. In addition, technological developments have made it feasible for cable television networks to carry data and voice communications. We are seeing new competition as a result of the development of commercial applications using Internet Protocol technology. This medium could attract substantial traffic because of its lower cost structure due to the fact that FCC rules do not currently impose access charges on most communications carried over this technology.

FRANCHISES AND LICENSES

Our local exchange business is typically provided under certificates of public convenience and necessity granted pursuant to state statutes and public interest findings of the various public utility commissions of the states in which we do business. These certificates provide for franchises of indefinite duration, subject to the maintenance of satisfactory service at reasonable rates. The Telecommunications Act of 1996 provides that these franchises must be non-exclusive.

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Domestic Wireless

OVERVIEW

Our domestic wireless business consists of our proportionate share of Cingular Wireless. Cingular is a joint venture that was formed by the combination of most of the former domestic wireless operations of BellSouth and SBC Communications. We have an approximate 40 percent economic interest in Cingular, and SBC has an approximate 60 percent economic interest. Cingular is operated independently from both parents, currently with a four-seat Board of Directors comprised of two directors from each parent. BellSouth and SBC share control of Cingular. Cingular is a SEC registrant by virtue of its publicly traded debt securities. Accordingly, it files separate reports with the SEC.

Cingular is the second largest provider of wireless voice and data communications services in the US in terms of customers. In addition, Cingular is one of the largest digital wireless network operators in the United States.

- Cingular has access to licenses, either through owned licenses or licenses owned by joint ventures and affiliates, to provide cellular or PCS wireless communications services covering an aggregate of 236 million in population (POPs), or approximately 81% of the US population, including in 45 of the 50 largest US metropolitan areas.
- Cingular provides cellular or PCS services in 43 of the 50 largest US metropolitan areas.
- 100% of Cingular s networks utilize digital technology.
- At December 31, 2003, 95% of Cingular s cellular and PCS customers were using digital service, and in December 2003, over 99% of Cingular s cellular and PCS minutes of use were digital.

Cingular provides a wide array of wireless services for individual, business and governmental users. Cingular s data services are offered over its cellular/PCS networks and its separate Mobitex network. On a combined basis, Cingular had approximately 5.5 million active users of its data services at December 31, 2002 and approximately 6.6 million at December 31, 2003.

In the US wireless telecommunications industry, there are two principal frequency bands currently licensed by the FCC for transmitting two-way voice and data signals. Analog and digital cellular services are provided over the 850 MHz band and digital PCS services are provided over the 1900 MHz band. PCS infrastructure is characterized by shorter transmission distances and closer spacing of cells and towers than in a cellular network to accommodate the different characteristics of the PCS radio signals. However, PCS service does not differ functionally to the end-user from digital cellular service.

On February 17, 2004, Cingular announced an agreement to acquire AT&T Wireless Services, Inc. in an all cash transaction. Under the terms of the agreement, which were approved by our board of directors and the boards of directors of SBC and Cingular as well as AT&T Wireless, shareholders of AT&T Wireless will receive $15 cash per common share or approximately $41 billion. The acquisition, which is subject to the approvals of AT&T Wireless shareholders and federal regulatory authorities, and to other customary closing conditions, is expected to be completed in the fourth quarter of 2004. The merger agreement provides that if the conditions to closing are not satisfied by December 31, 2004 it will be terminated, subject to extension to June 30, 2005 by either party if, as of December 22, certain regulatory approvals have not been obtained (in very limited circumstances it may be extended another 60 days thereafter). If AT&T Wireless enters into or consummates certain types of business combination transactions within fifteen months after certain terminations of the merger agreement, AT&T Wireless would be obligated to pay to BellSouth and SBC an aggregate termination fee equal to $1.4 billion.

The agreement provides that Cingular and AT&T Wireless are required to use their best efforts to consummate the merger as promptly as reasonably practicable and BellSouth and SBC are required to use reasonable best efforts to assist Cingular in obtaining regulatory approval. However, none of BellSouth, SBC nor Cingular will be required to take actions required by regulators as a condition to approval of the merger, and we will not be required to close the merger if the aggregate adverse impacts of required sales of subscribers or spectrum or any conditions imposed on either BellSouth, SBC and/or Cingular would exceed $8.25 billion. For purposes of calculating the impacts regarding sales of subscribers or spectrum, the parties have agreed that the adverse impact of (a) any required divestitures of a market would be equal to the number of subscribers in the market required to be divested multiplied by $825 and (b) any required divestitures of spectrum only would be equal to the amount of spectrum required to be divested multiplied by $.50 per MHz POP. Any other adverse impacts on BellSouth, SBC and/or Cingular would be calculated at the time the conditions are imposed. Each of SBC and BellSouth has agreed not to take any action reasonably likely to prevent the closing of the merger.

BUSINESS STRATEGY

Cingular s business strategy is to:

- expand its customer base profitably by continuing to promote the Cingular brand, by expanding and taking advantage of its extensive distribution capabilities and by cross-selling its products and services through bundling arrangements with its parents;

capture economies through its large scale and national scope, allowing it to further realize the significant revenue and cost synergies offered by its formation;

increase the capacity, speed and functionality of its cellular and PCS networks by deploying common voice and high-speed data technologies throughout its network;

develop and promote advanced wireless data applications over multiple communications devices; and

expand its existing footprint and its network capacity where economical by obtaining access to additional spectrum, primarily through acquisitions, ventures, alliances, spectrum exchanges and purchases and possible industry consolidation.

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NETWORK

Licenses

Cingular has licenses to provide cellular and PCS wireless services on the 850 MHz and 1900 MHz portions of the radio spectrum. Cingular provides both analog and digital cellular services on the 850 MHz band and digital services on the 1900 MHz band. Cingular also has 900 MHz licenses to provide data services.

Coverage

Cingular has access to wireless licenses to provide voice and data services over cellular/PCS networks in 45 of the 50 top wireless markets across the country. Cingular has also signed roaming agreements to ensure its customers can receive such wireless service in virtually all areas in the United States where cellular/PCS wireless service is available. Cingular s cellular/PCS networks are substantially built out. Cingular also provides wireless data services over its 900 MHz network, covering over 90% of the US metropolitan POPs, including the 50 largest US metropolitan areas.

Technology

Cingular uses both Global System for Mobile Communication (GSM) and Time Division Multiple Access (TDMA) technology. These are digital technologies that allow for numerous advantages over analog service, including extended battery life, improved voice quality, greater call security and lower per-minute costs. Digital service also enables enhanced features and services, such as interactive messaging, facsimile, e-mail and wireless connections to computer/data networks and the Internet. Further, GSM offers three to four times the voice capacity of TDMA digital technology and provides economies of scale due to its predominant global use.

Cingular is deploying high-speed General Packet Radio Service (GPRS) throughout its cellular and PCS networks and, at December 31, 2003, networks covering approximately 93% of its cellular and PCS wireless POPs were equipped with this technology. GPRS is an interim step towards Enhanced Data Rates for GSM Evolution (EDGE), Cingular s choice of third generation wireless technology. EDGE was launched in selected markets in 2003, with 20% of Cingular s operational POPs covered at December 31, 2003, and continued expansion planned for 2004. EDGE will increase the capacity, speed and functionality of Cingular s data networks. GPRS utilizes Internet Protocol-based technology, which allows for high-speed wireless packet-switched data services. Packet-switched technology allows for data to be sent and received in bursts, instead of requiring continuous transmission over the network for the duration of the communication, thereby providing the user always on, as opposed to dial-up, connectivity.

For data services, EDGE will offer faster speeds than TDMA or GSM circuit-switched or GPRS technology and is expected to provide Cingular s customers with greater connectivity and communications capabilities, including faster speeds for accessing the wireless Internet.

COMPETITION

There is substantial and increasing competition in all aspects of the wireless communications industry. Cingular competes for customers based principally on its service offerings, price, call quality, coverage area and customer service.

Cingular s competitors are principally the other largest national providers of cellular, PCS and other wireless communications services Verizon Wireless, AT&T Wireless, Sprint PCS, Nextel and T-Mobile, which together with Cingular, served almost 80% of the US wireless customers. Verizon Wireless ranks first among the six national carriers in terms of number of customers served as of December 31, 2003 and first in 2003 revenues and profitability. Cingular ranked second among these carriers according to number of customers served. Although AT&T Wireless had fewer customers, their 2003 revenues slightly exceeded Cingular s.

The primary advantages other carriers have over Cingular are spectrum depth and population coverage. Cingular addresses this by seeking additional licenses in areas where Cingular has current or future spectrum needs, via the following options:

- by participating in FCC auctions, such as the auction that ended in January 2001 that resulted in Cingular acquiring access, through Salmon PCS LLC, to an additional 45 licenses;
- by acquiring licenses from other carriers, either by direct purchases, as in Salt Lake City and the pending acquisition of licenses from NextWave, or by swaps for licenses, as in the New York metropolitan markets, in exchange for licenses for spectrum where Cingular has excess capacity; and
- by joint venturing with other carriers to pool spectrum or share network infrastructure, as in Cingular s AT&T and T-Mobile ventures.

In addition, because Cingular is in the process of overlaying its TDMA network with GSM/GPRS/EDGE technology and in the process of transitioning its TDMA customers to that new technology, Cingular will operate at somewhat of a disadvantage to other carriers (e.g., Verizon

Wireless, Sprint PCS, Nextel and T-Mobile) that utilize a common technology throughout their networks. Cingular is meeting these challenges by offering cellular and PCS phones that will operate on both TDMA and GSM networks as well as the standard GSM and TDMA only handsets and negotiating roaming agreements to allow its customers to use TDMA or GSM networks of other carriers. At the end of 2003, Cingular had 93% of its operational POPs covered by GSM/GPRS and 20% covered by EDGE.

As a result, Cingular believes it has the ability to strongly compete in all of its markets. Cingular also competes with smaller companies, resellers and wireline telephone service providers. Some of its competitors have greater financial, technical, marketing, distribution and other resources than Cingular does. In addition, some of the other large providers have more extensive coverage areas than Cingular does. Some of the indirect retailers who sell Cingular s services also sell its competitors services. Moreover, Cingular may experience significant competition from companies that provide similar services using other communications technologies and services. Some of these technologies and services are now operational and others are being developed or may be developed in the future.

Consolidation, alliances and business ventures may increase competition. Consolidation and the formation of alliances and business ventures within the wireless communications industry have occurred and Cingular expects that this trend will continue. Cingular has numerous other competing wireless providers in its markets. Consolidation may create larger, better-capitalized competitors with substantial financial, technical, marketing, distribution and other resources to compete with its product and service offerings. Competitors with more complete nationwide footprints may be able to offer nationwide services and plans more economically due to economies of scale and less dependence on roaming arrangements. In addition, global combinations of wireless carriers such as the alliance between AT&T Wireless and NTT DoCoMo Inc. of Japan, the joint venture between Sprint and Virgin Group, Verizon Wireless, which is a joint venture between Verizon and Vodafone plc, and mergers and acquisitions, such as the ownership of T-Mobile by Deutsche Telekom may give some domestic competitors better access to international technologies, marketing expertise and strategies and diversified sources of capital. Other large, national wireless carriers have affiliations with a number of smaller, regional wireless carriers that offer wireless services under the same national brand, thereby expanding the national carrier s perceived national scope. In addition, infrastructure sharing ventures, while facilitating Cingular s entry into new markets, also allows its partners to compete with Cingular in those markets.

Governmental policy at all levels favors robust competition. For example, under current FCC rules, six or more PCS licensees, two cellular licensees and one or more enhanced specialized mobile radio, or ESMR , licensees may operate in each geographic area. This structure has resulted in the presence of multiple competitors in Cingular s markets and makes it challenging for Cingular to attract new customers and retain existing ones. In addition, specialized mobile radio, or SMR , dispatch system operators have constructed two-way ESMR digital mobile communications systems on existing SMR frequencies in many cities throughout the United States, including most of the markets in which Cingular operates.

Cingular s ability to compete successfully will depend, in part, on the quality of its network and marketing efforts and on its ability to anticipate and respond to various competitive factors affecting the industry. These factors include the introduction of new services and technologies, changes in consumer preferences, demographic trends, economic conditions, pricing strategies of competitors and its ability to take advantage of its wireless/wireline service area overlap with SBC and BellSouth. As a result of competition, Cingular has in the past and may in the future be required to:

- reduce prices for its services and products;
- restructure its service packages to provide more services without increasing prices;
- further upgrade its network infrastructure and the handsets Cingular offers;
- increase its advertising, promotional spending, commissions and other customer acquisition costs; and
- increase its spending to retain customers.

As previously discussed, on February 17, 2004, Cingular announced an agreement to acquire AT&T Wireless. We expect that this acquisition will enhance Cingular s ability to compete by strengthening its network coverage and quality and improving customer service and offerings.

On November 24, 2003, the FCC s rules on wireless local number portability became operative, enabling wireless customers to keep their wireless number when switching to another carrier. These rules require wireless carriers to offer number portability to their customers in the top 100 metropolitan statistical areas (MSAs) now and to all other customers no later than May 24, 2004. These rules will likely increase competition, costs and customer churn.

REGULATORY ENVIRONMENT

The FCC regulates the licensing, construction, operation, acquisition and transfer of wireless systems in the United States pursuant to the Communications Act of 1934 and its associated rules, regulations and policies.

To obtain the authority to have the exclusive use of radio frequency spectrum in an area within the United States, wireless communications systems must be licensed by the FCC to operate the wireless network and mobile devices in assigned spectrum segments and must comply with the rules and policies governing the use of the spectrum as adopted by the FCC. These rules and policies, among other things:

- regulate Cingular s ability to acquire and hold radio spectrum licenses;
- impose technical obligations on the operation of Cingular s network;
- impose requirements on the ways Cingular provides service to and communicates with its customers;
- regulate the interconnection of its network with the networks of other carriers;
- obligate Cingular to serve roaming customers of other wireless carriers; and
- impose a variety of fees and charges on its business that are used to finance numerous regulatory programs and part of the FCC s budget.

Licenses are issued for only a fixed period of time, typically 10 years. Consequently, Cingular must periodically seek renewal of those licenses. The FCC will award a renewal expectancy to a wireless licensee that has provided substantial service during its past license term and has substantially complied with applicable FCC rules and policies and the Communications Act of 1934. The FCC has routinely renewed wireless licenses in the p