

Table of Contents
Financials

28
Selected Financial Data

29
Management's
Discussion and Analysis
of Financial Condition
and Results of Operations

36
Financial Statements

Consolidated Balance Sheets
as of December 31, 1997 and 1996

Consolidated Statements
of Operations
for the Years Ended
December 31, 1997,
1996, and 1995

Consolidated Statements
of Stockholders' Equity
for the Years Ended
December 31, 1997,
1996, and 1995

Consolidated Statements
of Cash Flows
for the Years Ended
December 31, 1997,
1996, and 1995

42
Notes to Consolidated
Financial Statements

55
Independent
Auditors' Report

56
Market for the Registrant's
Common Stock and Related
Shareholder Matters

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with the Company's accompanying audited consolidated financial statements and the notes thereto appearing elsewhere in this document.

Overview

The Company is a facilities-based provider of multimedia communications services to interexchange carriers and other communications entities ("Carrier Services") and to businesses and consumers ("Commercial Services"); and it constructs and installs fiber-optic communications systems for interexchange carriers and other communications entities, as well as for its own use ("Network Construction Services").

The Company is expanding its existing voice and data network into the Qwest Network, an approximately 16,250 route-mile, coast-to-coast, technologically advanced fiber-optic telecommunications network. The domestic network is expected to be completed in 1999. The Company is also expanding its network to carry international data and voice traffic into Mexico and the United Kingdom through London. Completion of the Mexico network is scheduled for late 1998. The network extension to London will be obtained through the exchange of telecommunications capacity with Teleglobe Inc., including two 155-megabit circuits crossing the Atlantic Ocean from New York City to London. The transatlantic telecommunications capacity supports the Company's growth into the European market. The Company's European services will be terminated in London.

In October 1997, the Company acquired SuperNet, Inc. ("SNI"), an Internet service provider ("ISP") for \$20.2 million in cash, including acquisition costs.

In January 1998, the Company signed a definitive merger agreement to acquire Phoenix Network, Inc. ("Phoenix Network"), a non-facilities-based reseller of long distance services.

Phoenix Network currently has approximately 40,000 customers, primarily in the business market. The transaction is subject to the approval of the Phoenix Network stockholders, the receipt of certain state and federal regulatory approvals, and the satisfaction of other customary closing conditions. The meeting of Phoenix Network stockholders to consider approval of the acquisition is scheduled for March 30, 1998.

In March 1998, the Company signed a definitive merger agreement with LCI International, Inc. ("LCI"), a communications services provider. The boards of directors of each company have approved the merger. The terms of the merger agreement call for the acquisition of all of LCI's outstanding common shares and the assumption of all of LCI's stock options by the Company. The purchase price of the all-stock transaction is anticipated to be approximately \$4.4 billion. The merger is intended to qualify as a tax-free reorganization and will be accounted for as a purchase. Completion of the merger is anticipated to occur during the third quarter of 1998.

Carrier Services. Carrier Services provide high-volume and conventional dedicated line services over the Company's owned capacity and switched services over owned and leased capacity to interexchange carriers and other telecommunications providers. The Company is expanding Carrier Services to increase its revenue stream and reduce per unit costs, targeting capacity sales on a segment-by-segment basis as the Qwest Network is deployed and activated, and is increasingly seeking longer-term, high-volume capacity agreements from major carriers. In addition to traditional telecommunications carriers, the Company is marketing to ISPs and other data service companies. For the years ended December 31, 1997, and 1996, the Company's five largest carrier customers accounted for approximately 42.3% and 41.3% of Carrier Services revenue, respectively.

Commercial Services. Commercial Services provide voice, data, and video services to businesses and consumers. The Company plans to expand its presence in the Commercial Services market by developing its distinctive "Ride the Light"SM brand identity and aggressively marketing its existing and planned voice, data, and other transmission products and services. The Company plans to build direct, end-user relationships by developing strong distribution channels, providing competitive pricing and superior network quality, and offering enhanced, market-driven services to businesses and consumers.

Revenue from Commercial Services is recognized primarily on a minutes-of-use basis. Commercial Services has generated revenue using four primary sales channels: direct sales, direct mail, agent, and telemarketing. In September 1997, the Company entered into an arrangement with a third party under which they will jointly define and test new broadband business multimedia services. The Company also entered into marketing agreements in September 1997 with two additional third parties. Under one agreement, a marketing company that wholesales and retails telecommunications products on a national basis will act as an authorized sales representative of Qwest and will market the Company's long-distance products through affinity groups. Under the other agreement, the Company will offer its One Plus and Calling Card services (with competitive international pricing for both) and other services to utilities in the United States under the Simple ChoiceSM brand name of that third party.

Network Construction Services. Network Construction Services construct and install fiber-optic communication systems for interexchange carriers and other telecommunications providers, as well as for the Company's own use. The Company began operations in 1988 construct-

ing fiber-optic conduit systems primarily for major long distance carriers in exchange for cash and capacity rights. In 1996, the Company entered into major construction contracts for the sale of dark fiber to Frontier and WorldCom whereby the Company has agreed to install and provide dark fiber to each along portions of the Qwest Network. The company also entered into two substantial construction contracts with GTE in 1997 for the sale of dark fiber along portions of the route of the Qwest Network. After completion of the Qwest Network, the Company expects that revenue from Network Construction Services will be less significant to the Company's operations.

Revenue from Network Construction Services generally is recognized under the percentage of completion method as performance milestones relating to the contract are satisfactorily completed. Losses, if any, on uncompleted contracts are expensed in the period in which they are identified and any revisions to estimated profits on a contract are recognized in the period in which they become known.

Results of Operations

Year Ended December 31, 1997 Compared to Year Ended December 31, 1996

The Company reported net earnings of \$14.5 million in the year ended December 31, 1997, compared to a net loss of \$7.0 million in the same period of the prior year. Excluding the effect of the compensation expense relating to the Growth Share Plan, net of income tax, the Company's reported net earnings would have been approximately \$61.6 million and \$1.5 million for the years ended December 31, 1997, and 1996, respectively.

Revenue. Total revenue increased \$465.7 million, or 202%, during the year ended December

31, 1997, as compared to 1996. Carrier Services revenue decreased \$1.9 million, or 3%, for the year ended December 31, 1997, as compared to 1996, primarily due to the Company's sale of its resale dedicated line services on leased capacity on July 1, 1996. The sold business generated revenue of \$18.8 million for the year ended December 31, 1996. Exclusive of this revenue, Carrier Services revenue increased \$16.9 million, or 44%, during the year ended December 31, 1997, as compared to 1996. This increase in Carrier Services revenue was due primarily to increases in revenue from carrier switched services and carrier dedicated line services provided on the Qwest Network. Commercial Services revenue increased \$25.4 million, or 74%, for the year ended December 31, 1997, as compared to 1996. The increase was due primarily to growth in switched services provided to small and medium-sized businesses and to consumers as a result of continued expansion of the Company's direct sales, direct mail, agent, and telemarketing sales channels. Revenue from Network Construction Services increased \$442.2 million, or 318%, during the year ended December 31, 1997, as compared to the corresponding period in 1996. The increase was due primarily to revenue from dark fiber sales to WorldCom, GTE, and Frontier.

Operating Expenses. The Company's principal operating expenses consist of expenses for telecommunications services, network construction incurred by Network Construction Services, expenses for selling, general and administrative expenses (SG&A), Growth Share Plan expense, and depreciation and amortization. Total operating expenses increased \$430.2 million, or 177%, during the year ended December 31, 1997, as compared to the corresponding period in 1996. Expenses for telecommunications services primarily consist of the cost of leased capacity, Local Exchange Carrier ("LEC") access charges, engineering, and other operating costs. Expenses

for telecommunications services increased \$10.8 million, or 13%, for the year ended December 31, 1997, as compared to 1996. The growth in telecommunications services expenses was primarily attributable to the continued growth in switched services and network engineering and operations, partially offset by the reduction in expenses resulting from the sale on July 1, 1996 of the Company's resale dedicated line services on leased capacity and an increase in on-net traffic over the Qwest Network. When the Qwest Network is completed and activated, the Company will be able to serve more customer needs over its own capacity on the Qwest Network.

Expenses for Network Construction Services consist primarily of costs to construct the Qwest Network, including conduit, fiber cable, construction crews, and rights of way. Costs attributable to the construction of the Qwest Network for the Company's own use are capitalized. Expenses for Network Construction Services increased \$309.6 million, or 354%, in the year ended December 31, 1997, as compared to 1996, due to costs of construction contracts relating to increased dark fiber sales revenue.

SG&A includes the cost of salaries, benefits, occupancy costs, commissions, sales and marketing expenses, and administrative expenses. SG&A increased \$45.4 million, or 99%, in the year ended December 31, 1997, as compared to 1996. The increase was due primarily to increases in expenses related to the Company's direct mail sales program, the development of the Company's new brand identity, administrative and information services in support of the Company's growth, and the recruiting and hiring of additional personnel. The Company is in the process of opening commercial sales offices in selected major geographic markets to implement the Company's strategy, as segments of the Qwest Network become operational. In addition, SG&A expenses will increase as the Company

continues to expand its Carrier and Commercial Services, initiate its United States and international direct sales operations, and recruit experienced telecommunications industry personnel to implement the Company's strategy.

The Company has a Growth Share Plan for certain of its employees and directors. Growth Share Plan expense reflects the Company's estimate of compensation expense with respect to the Growth Shares issued to participants. A "Growth Share" is a unit of value based on the increase in value of the Company over a specified measuring period. The Company estimated an increase in the value of Growth Shares, primarily triggered by the June 1997 initial public offering (the "IPO"), and has recorded \$73.5 million of additional compensation expense in the year ended December 31, 1997, and \$13.1 million in the year ended December 31, 1996. The Company anticipates total additional expense of up to approximately \$23.4 million through the year 2002 in connection with this plan. The Company does not anticipate any future grants under the Growth Share Plan.

The Company's depreciation and amortization expense increased \$4.0 million, or 25%, during the year ended December 31, 1997, as compared to 1996. This increase resulted primarily from activating segments of the Qwest Network, during 1997, purchases of additional equipment used in constructing the Qwest Network, and purchases of other fixed assets to accommodate the Company's growth. The Company expects that depreciation and amortization expense will continue to increase in subsequent periods as the Company continues to activate additional segments of the Qwest Network and amortizes the goodwill acquired with the SNI purchase (discussed above).

Other Income (Expense). Pursuant to a capacity sale in 1993, the Company obtained certain rights of first refusal to re-acquire network

communications equipment and terminal locations including leasehold improvements should the purchaser, under that agreement, sell the network. In the first quarter of 1997, the Company sold certain of these rights to the purchaser in return for \$9.0 million in cash and the right to re-acquire certain terminal facilities, which the Company received in 1997 and has recorded as gain on sale of contract rights.

During 1997, the Company's net interest income (expense) increased \$2.8 million, as compared to 1996. The increase resulted from an increase in interest on long-term indebtedness, related primarily to the 107/8% Notes and the 9.47% Notes (see "Liquidity and Capital Resources" below), partially offset by increases in capitalized interest resulting from construction of the Qwest Network and interest income attributable to the increase in cash equivalent balances. In January 1998, the Company issued the 8.29% Notes (see "Liquidity and Capital Resources" below), which are expected to increase net interest expense in subsequent periods.

As previously discussed, the Company sold a portion of its dedicated line services on leased capacity in July 1996. During the transition of the service agreements to the buyer, the Company incurred certain facilities costs on behalf of the buyer, which were to be reimbursed to the Company. A dispute arose with respect to the reimbursement of such costs and, as a result, the Company made a provision of approximately \$2.0 million in the first quarter of 1997.

Income Taxes. The Company is included in the consolidated federal income tax return of Anschutz Company (the "Majority Shareholder"). A tax-sharing agreement provides for allocation of tax liabilities and benefits to the Company, in general, as though it filed a separate tax return. The Company's effective tax rate in 1997 was higher than the statutory federal rate as a result of permanent differences between book and tax

expense relating to the Growth Share Plan and amortization of goodwill. The Company's effective tax rate in the year ended December 31, 1996, approximated the statutory federal rate.

Net Earnings (Loss). The Company realized net earnings of \$14.5 million in the year ended December 31, 1997, as compared to a net loss of \$7.0 million in the corresponding period of 1996 as a result of the factors discussed above.

Year Ended December 31, 1996 Compared to Year Ended December 31, 1995

Revenue. Total revenue increased \$105.9 million, or 85%, due primarily to significantly higher revenue from Network Construction Services, as well as increased revenue from Commercial Services, offset in part by lower revenue from Carrier Services. Revenue from Network Construction Services increased \$102.3 million, or 277%, due to revenue from dark fiber sales of approximately \$121.0 million to WorldCom and Frontier. Commercial Services revenue increased \$13.9 million, or 68%. This increase is largely attributable to growth in switched services provided to small and medium-sized businesses and consumers as a result of the expansion of the Company's agent, telemarketing, and direct mail sales channels. Carrier Services revenue decreased \$10.2 million or 15%, primarily due to decreases in revenue resulting from the Company's sale of a portion of its dedicated line services on leased capacity on July 1, 1996. The sold business generated revenues of \$18.8 million for the year ended December 31, 1996 and \$39.7 million for the year ended December 31, 1995. The decrease in Carrier Services revenue was partially offset by an increase in revenue from carrier switched services, which increased to \$19.4 million in 1996 from \$13.8 million in 1995.

Operating Expenses. Total operating expenses increased \$81.9 million, or 51%, due

primarily to increases in Network Construction Services, SG&A, and compensation expenses associated with the Growth Share Plan. Expenses for telecommunications services decreased \$0.8 million or 1%. The sale on July 1, 1996, of the Company's dedicated line services on leased capacity generated a reduction in expenses, which was partially offset by an increase in telecommunications services expenses associated with the growth in switched services and servicing the Qwest Network. Expenses for Network Construction Services increased \$54.8 million or 167%. This increase was due to cost of construction contracts relating to increased dark fiber sales.

SG&A expenses increased \$8.6 million, or 23%. The Company incurred additional SG&A expenses as a result of growth in the Company's telecommunications services and the construction of the Qwest Network, including additional sales commissions on higher revenue, expenses incurred in the implementation of the Company's direct mail sales channel, and expenses for customer service personnel added to support the Company's expansion of its commercial customer base. The SG&A expenses in 1996 also included restructuring expenses of \$1.6 million incurred by the Company as a result of its decision to close 13 sales offices and the termination of approximately 130 employees involved in sales, marketing, and administrative functions. As a result of this restructuring, the Company experienced a reduction in payroll, commissions, and rental expense. The Company anticipates that, as it deploys the Qwest Network and expands its Carrier Services and Commercial Services, SG&A expenses will continue to increase.

The Company estimated a \$13.1 million increase in value of the Growth Shares at December 31, 1996, due to the Frontier dark fiber sale. No expense was recognized for the year ended December 31, 1995, as there were no sig-

nificant compensatory elements in those periods.

The Company's depreciation and amortization expense increased \$6.3 million, or 63%. This increase was primarily due to the Company's investment in the Qwest Network. The Company expects that depreciation and amortization expense will continue to increase in subsequent periods as the Company continues to activate additional segments of the Qwest Network.

Other Income (Expense). The Company's net interest and other expenses increased \$1.9 million, or 79%. This increase was primarily attributable to additional debt incurred in 1996 to finance capital expenditures and to provide working capital. (See discussion of additional indebtedness in "Liquidity and Capital Resources" below.)

Income Taxes. The Company is included in the consolidated federal income tax return of the Majority Shareholder. A tax sharing agreement provides for allocation of tax liabilities and benefits to the Company, in general, as though it filed a separate tax return. The Company's effective tax rate in 1996 and 1995 approximated the statutory federal rate. The difference between the income tax benefit of \$3.2 million in 1996 as compared to \$13.3 million in 1995 resulted from a \$28.3 million decrease in loss before income taxes.

Net Loss. The Company experienced a net loss of \$7.0 million in 1996 compared to a net loss of \$25.1 million in 1995 as a result of the factors discussed above.

In June 1997, the FASB issued Statement of Financial Accounting Standards No. 131, *Disclosure About Segments of an Enterprise and Related Information* ("SFAS 131"). SFAS 131 establishes standards for the manner in which business enterprises are to report information about operating segments in its annual statements and requires those enterprises to report selected information regarding operating segments in interim financial reports issued to share-

holders. SFAS 131 is effective for fiscal years beginning after December 15, 1997.

Liquidity and Capital Resources

From January 1, 1995, through March 31, 1997, the Company funded capital expenditures, debt service, and cash used in operations through a combination of stockholder advances, capital contributions, and external borrowings supported by collateral owned by the Majority Shareholder or affiliates, as well as external borrowings collateralized by certain of the Company's assets. During the remainder of 1997, the Company funded capital expenditures and long-term debt repayments primarily through net proceeds from the issuance of debt and equity securities aggregating approximately \$903.6 million. The Company also received net proceeds of \$299.2 million from the issuance of the 8.29% Notes in January 1998. The Company intends to finance its operations in the future through internally and externally generated funds without relying on cash advances, contributions, or guarantees from the Majority Shareholder.

Total cash expended during the three years ended December 31, 1997, to fund capital expenditures, repayments of long-term debt to third parties, repayment of net advances from the Majority Shareholder, and for acquisitions was \$449.2 million, \$223.9 million, \$9.9 million, and \$32.6 million, respectively. Total cash used in operations was \$60.6 million during the same period. Total cash provided during this same period from revolving loans secured by collateral owned by the Majority Shareholder or an affiliate was \$138.0 million, and capital contributions from the Majority Shareholder were approximately \$28.0 million. The loans from the Majority Shareholder were repaid in 1997. In addition, during this same period, the Company's net cash provided by secured

borrowings under long-term debt agreements with third parties aggregated \$67.6 million. As of December 31, 1997, the Company had positive working capital of \$408.5 million resulting primarily from the issuance of the 9.47% Notes in October 1997. At December 31, 1996 and 1995, the Company had working capital deficits of approximately \$75.7 million and \$2.6 million, respectively.

The Company estimates the total cost to construct and activate the Qwest Network and complete construction of the dark fiber sold to Frontier, WorldCom, and GTE will be approximately \$1.9 billion. Of this amount, the Company had already expended approximately \$850.0 million as of December 31, 1997. The Company anticipates remaining total cash outlays (including capital expenditures) for these purposes of approximately \$881.0 million in 1998 and \$195.0 million in 1999. Estimated total Qwest Network expenditures for 1998 include the Company's commitment to purchase a minimum quantity of fiber for approximately \$399.0 million (subject to quality and performance specifications), of which approximately \$252.0 million had been expended as of December 31, 1997. Estimated total expenditures for 1998 and 1999 together also include approximately \$92.0 million for the purchase of electronic equipment. In addition, the Company anticipates approximately \$557.0 million of capital expenditures in 1998 and 1999 to support growth in Carrier Services and Commercial Services.

As of December, 1997, the Company has obtained the following sources of funds that are available to complete the build-out: (i) approximately \$1.2 billion under the Frontier, WorldCom, and GTE contracts and additional smaller construction contracts for sales of dark fiber, of which approximately \$430.0 million had already been received and \$770.0 million remained to be paid at December 31, 1997;

(ii) \$90.0 million of vendor financing; (iii) \$242.0 million in net proceeds from the sale of the 10 7/8% Notes, of which approximately \$124.4 million was used to pay down certain existing debt; (iv) \$342.1 million in net proceeds from the sale of the 9.47% Notes; and (v) approximately \$319.5 million in net proceeds from the IPO. The Company believes that its available cash and cash equivalent balances at December 31, 1997, the net proceeds from issuance of the 8.29% Notes in January 1998 and cash flow from operations will satisfy its currently anticipated cash requirements at least through the end of 1998.

In January 1998, the Company issued its 8.29% Notes, generating net proceeds of approximately \$299.2 million, after deducting offering costs. The 8.29% Notes will accrete at a rate of 8.29% per annum, compounded semi-annually, to an aggregate principal amount of \$450.5 million by February 1, 2003. The 8.29% Notes mature on February 1, 2008. The 8.29% Notes are redeemable at the Company's option, in whole or in part, at any time on or after February 1, 2003, at specified redemption prices. Cash interest on the 8.29% Notes will not accrue until February 1, 2003, and thereafter will accrue at a rate of 8.29% per annum, and will be payable semiannually in arrears commencing on August 1, 2003, and thereafter on February 1 and August 1 of each year. The 8.29% Notes indenture contains certain covenants that, among other things, limit the ability of the Company and certain of its subsidiaries (the "Restricted Subsidiaries") to incur additional indebtedness and issue preferred stock, pay dividends, or make other distributions, repurchase capital stock or subordinated indebtedness, create certain liens, enter into certain transactions with affiliates, sell assets of the Company or its Restricted Subsidiaries, issue or sell capital stock of the Company's Restricted Subsidiaries or enter into certain mergers and consolidations.

In connection with the sale of the 8.29% Notes, the Company agreed to make an offer to exchange new notes, registered under the Securities Act of 1933 (the "Act") and with terms identical in all material respects to the 8.29% Notes, for the 8.29% Notes or, alternatively, to file a shelf registration statement under the Act with respect to the 8.29% Notes. If the registration statement for the exchange offer or the shelf registration statement, as applicable, is not filed or declared effective within specified time periods or, after being declared effective, ceases to be effective or usable for resale of the 8.29% Notes during specified time periods (each a "Registration Default"), additional cash interest will accrue at a rate per annum equal to 0.50% of the principal amount at maturity of the 8.29% Notes during the 90-day period immediately following the occurrence of a Registration Default and increasing in increments of 0.25% per annum of the principal amount at maturity of the 8.29% Notes up to a maximum of 2.0% per annum, at the end of each subsequent 90-day period until the Registration Default is cured.

In October 1997, the Company issued and sold its 9.47% Notes, generating net proceeds of approximately \$342.1 million, after deducting offering costs. The 9.47% Notes will accrete at a rate of 9.47% per annum, compounded semiannually, to an aggregate principal amount of \$555.9 million by October 15, 2002. The 9.47% Notes mature on October 15, 2007. The 9.47% Notes are redeemable at the Company's option, in whole or in part, at any time on or after October 15, 2002, at specified redemption prices. Cash interest on the 9.47% Notes will not accrue until October 15, 2002, and thereafter will accrue at a rate of 9.47% per annum, and will be payable semiannually in arrears commencing on April 15, 2003, and thereafter on April 15 and October 15 of each year. The indenture for the 9.47% Notes contains certain covenants that

are substantially identical to the 8.29% Notes described above. In February 1998, the Company completed an exchange of identical notes, registered under the Act, for all of the 9.47% Notes.

In June 1997, the Company received approximately \$319.5 million in net proceeds from the sale of 31,050,000 shares of the Company's Common Stock in the IPO.

In May 1997, the Company and Nortel, individually and as agent for itself and other specified lenders, entered into a \$90.0 million credit agreement (the "Equipment Credit Facility") to fund a portion of certain capital expenditures required to equip the Qwest Network. Under the Equipment Credit Facility, the Company may borrow funds up to 75% of the purchase price of such equipment and related engineering and installation services provided by Nortel as vendor as it purchases the equipment, with the purchased equipment and related items serving as collateral for the loans of a third party lender. The Company is committed to purchase from Nortel a minimum of \$100.0 million of such equipment and services under a separate procurement agreement. The Company's total remaining commitment under the procurement agreement was approximately \$68.4 million as of December 31, 1997. Principal amounts outstanding under the Equipment Credit Facility will be payable in quarterly installments commencing on June 30, 2000, with full repayment due on March 31, 2004. Borrowings bear interest at the Company's option at either: (i) a floating base rate announced by a designated reference bank plus an applicable margin; or (ii) LIBOR plus an applicable margin.

In March 1997, the Company issued and sold its 10 7/8% Notes, generating net proceeds of approximately \$242.0 million, after deducting offering costs. A portion of the net proceeds were used to repay amounts due under the then

existing revolving credit facility, the construction term loan, equipment loans and term notes, described below. Interest on the 10 7/8% Notes is payable semiannually in arrears on April 1 and October 1 of each year, commencing October 1, 1997. The 10 7/8% Notes mature on April 1, 2007. The 10 7/8% Notes are subject to redemption at the option of the Company, in whole or in part, at any time on or after April 1, 2002, at specified redemption prices. The indenture for the 10 7/8% Notes contains certain covenants that are substantially identical to the 8.29% and 9.47% Notes described above.

In 1996, the Company entered into and subsequently amended a long-term \$100.0 million revolving credit facility agreement, which was collateralized by shares of common stock owned and pledged by the Majority Shareholder. In October 1997, the Company repaid the outstanding balance and terminated this facility.

In April 1995, the Company entered into a secured construction loan facility used to fund certain conduit installation projects. The facility converted to a term loan upon completion of the construction projects in 1996 and 1995 and became secured by notes receivable issued in connection with the projects. The term loan bore interest at the Company's option at either (i) the higher of (a) the bank's base rate of interest, or (b) the Federal Funds Rate plus 1/2%; or (ii) LIBOR plus 9/16%. The outstanding balance of \$10.9 million at December 31, 1997, was repaid subsequent to year end.

The Company also incurred other indebtedness during the three-year period ended December 31, 1997, including five equipment loans in 1995 and 1996 aggregating \$10.0 million and two term notes in January 1995 aggregating \$12.0 million, the proceeds of which were used to repay a portion of the prior advance from the Majority Shareholder. In addition, the Company had other outstanding

indebtedness in 1997, which it had incurred prior to 1995, including amounts payable under a network credit facility and an additional equipment loan. Such indebtedness had a weighted average interest rate of approximately 9% in 1997, and was repaid in the second quarter of 1997 with proceeds from the 10 7/8% Notes.

Year 2000

The Company has created a project team including internal and external resources that is in the process of identifying and addressing the impact of problems and uncertainties related to the year 2000 on its operating and application software and products. The Company expects to resolve year 2000 compliance issues primarily through replacement and normal upgrades of its software and products. However, there can be no assurance that such replacements and upgrades can be completed on schedule and within the estimated costs.

Inflation

Inflation has not significantly affected the Company's operations during the past three years.

Information Regarding Forward-looking Statements

This annual report contains forward-looking statements within the meaning of federal securities laws, including statements about the Company's plans to complete its approximately 16,250 route mile, coast-to-coast, technologically advanced, fiber-optic telecommunications network, expectations as to funding its capital requirements, anticipated expansion of carrier services and commercial services, regulatory and pricing trend projections, and other statements of expectations, beliefs, future plans and strategies, anticipated developments, and other matters that are not historical facts. Management cautions the reader that these forward-looking statements are subject to

risks and uncertainties that could cause actual events or results to differ materially from those expressed or implied by the statements. Important factors that could prevent the Company from achieving its stated goals include, but are not limited to: (i) failure of the Company to manage effectively, cost efficiently, and on a timely basis the construction of the Qwest Network (see definition below) route segments; (ii) failure to enter into additional customer contracts to sell dark fiber or provide high-volume capacity and otherwise expand its telecommunications customer base; (iii) failure to obtain and maintain all necessary rights of way; (iv) intense competition in the Company's carrier services and commercial services markets; (v) the potential for rapid and significant changes in technology and their effect on the Company's operations; (vi) operating and financial risks related to managing rapid growth and integrating acquired businesses; (vii) adverse changes in the regulatory environment; and (viii) risks of being highly leveraged and sustaining operating cash deficits. For additional information, see "Risk Factors" included in the Company's registration statement on Form S-4, No. 333-46145, and other Company filings with the SEC.

CONSOLIDATED BALANCE SHEETS
December 31, 1997 and 1996
(In Thousands, Except Share and Per Share Information)

Assets	<u>1997</u>	<u>1996</u>
Current assets:		
Cash and cash equivalents	\$ 379,784	\$ 6,905
Accounts receivable, net	67,395	29,248
Costs and estimated earnings in excess of billings	256,566	4,989
Notes and other receivables	10,855	14,934
Other current assets	9,342	328
Total current assets	<u>723,942</u>	<u>56,404</u>
Property and equipment, net	614,640	186,535
Deferred income tax asset	17,988	4,593
Notes and other receivables	59	11,052
Intangible and other long-term assets, net	41,476	3,967
Total assets	<u>\$ 1,398,105</u>	<u>\$ 262,551</u>

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEETS, continued
December 31, 1997 and 1996
(In Thousands, Except Share and Per Share Information)

Liabilities and Stockholders' Equity	1997	1996
Current liabilities:		
Accounts payable and accrued expenses	\$ 253,313	\$ 80,129
Billings in excess of costs and estimated earnings	21,390	5,034
Deferred income tax liability	22,344	—
Current portion of long-term debt	12,011	25,193
Payable to Majority Shareholder	2,091	19,138
Deferred revenue	4,273	2,649
Total current liabilities	315,422	132,143
Long-term debt	630,463	109,268
Other liabilities	70,476	11,698
Total liabilities	1,016,361	253,109
Stockholders' equity:		
Preferred Stock, \$.01 par value. Authorized 25,000,000 shares. No shares issued and outstanding.	—	—
Common Stock, \$.01 par value. Authorized 400,000,000 shares. 206,669,874 shares and 173,000,000 shares issued and outstanding at December 31, 1997, and December 31, 1996, respectively.	2,066	1,730
Additional paid-in capital	411,605	54,162
Accumulated deficit	(31,927)	(46,450)
Total stockholders' equity	381,744	9,442
Commitments and contingencies		
Total liabilities and stockholders' equity	\$1,398,105	\$ 262,551

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF OPERATIONS
For the Years Ended December 31, 1997, 1996, and 1995
(In Thousands, Except Per Share Information)

	1997	1996	1995
Revenue:			
Carrier services	\$ 55,644	\$ 57,573	\$ 67,789
Commercial services	59,649	34,265	20,412
	115,293	91,838	88,201
Network construction services	581,410	139,158	36,901
	696,703	230,996	125,102
Operating expenses:			
Telecommunications services	91,166	80,368	81,215
Network construction services	397,153	87,542	32,754
Selling, general, and administrative	91,190	45,755	37,195
Growth share plan	73,451	13,100	—
Depreciation and amortization	20,262	16,245	9,994
	673,222	243,010	161,158
Earnings (loss) from operations	23,481	(12,014)	(36,056)
Other income (expense):			
Interest expense, net	(18,895)	(6,827)	(4,248)
Interest income	11,708	2,454	1,782
Other income, net	7,286	6,186	55
Earnings (loss) before income taxes	23,580	(10,201)	(38,467)
Income tax expense (benefit)	9,057	(3,234)	(13,336)
Net earnings (loss)	\$ 14,523	\$ (6,967)	\$ (25,131)
Earnings (loss) per share – basic	\$ 0.08	\$ (0.04)	\$ (0.15)
Earnings (loss) per share – diluted	\$ 0.07	\$ (0.04)	\$ (0.15)

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Years Ended December 31, 1997, 1996, and 1995

(In Thousands, Except Per Share Information)

	Common Stock		Additional paid-in capital	Accumulated deficit	Total stockholders' equity
	Number of shares	Amount			
Balances, January 1, 1995	173,000,000	\$ 1,730	\$ 37,203	\$ (14,352)	\$ 24,581
Cash contribution from Majority Shareholder	—	—	28,000	—	28,000
Reduction in additional paid-in capital attributable to effect of the tax allocation agreement with Majority Shareholder	—	—	(975)	—	(975)
Net loss	—	—	—	(25,131)	(25,131)
Balances, December 31, 1995	173,000,000	1,730	64,228	(39,483)	26,475
Cancellation of income tax benefit receivable from Majority Shareholder	—	—	(11,088)	—	(11,088)
Equity contribution from Majority Shareholder	—	—	1,022	—	1,022
Net loss	—	—	—	(6,967)	(6,967)
Balances, December 31, 1996	173,000,000	1,730	54,162	(46,450)	9,442
Issuance of common stock in initial public offering, net	31,050,000	310	319,171	—	319,481
Issuance of common stock warrants	—	—	2,300	—	2,300
Issuance of common stock for Growth Shares	2,591,532	26	35,284	—	35,310
Issuance of common stock upon exercise of employee stock options	9,644	—	132	—	132
Issuance of common stock under Equity Incentive Plan	18,698	—	556	—	556
Net earnings	—	—	—	14,523	14,523
Balances, December 31, 1997	206,669,874	\$ 2,066	\$ 411,605	\$ (31,927)	\$ 381,744

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 1997, 1996, and 1995
(In Thousands)

	1997	1996	1995
Cash flows from operating activities:			
Net earnings (loss)	\$14,523	\$(6,967)	\$(25,131)
Adjustments to reconcile net earnings (loss) to net cash (used in) provided by operating activities:			
Depreciation and amortization	20,262	16,245	9,994
Gain on sale of contract rights	(9,296)	—	—
Gain on sale of telecommunications service agreements	—	(6,126)	—
Deferred income tax expense (benefit)	8,949	(1,123)	(2,839)
Changes in operating assets and liabilities:			
Receivables – accounts and notes, net	(22,397)	(25,680)	(21,379)
Costs and estimated earnings in excess of billings, net	(235,221)	24,172	(21,650)
Accounts payable and accrued liabilities	189,797	34,455	5,852
Payable to related parties, net	—	(2,983)	1,263
Other changes	(3,105)	531	(2,745)
Net cash (used in) provided by operating activities	(36,488)	32,524	(56,635)
Cash flows from investing activities:			
Proceeds from sale of contract rights	9,000	—	—
Proceeds from sale of telecommunications service agreements	—	4,500	—
Expenditures for property and equipment	(345,788)	(57,122)	(46,313)
Cash paid for acquisitions, net of cash acquired	(20,036)	—	(12,545)
Net cash used in investing activities	\$(356,824)	\$(52,622)	\$(58,858)

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS, *continued*
For the Years Ended December 31, 1997, 1996, and 1995
(In Thousands)

	1997	1996	1995
Cash flows from financing activities:			
Proceeds from issuance of common stock in initial public offering, net	\$ 319,481	\$ —	\$ —
Proceeds from issuance of common stock warrants	2,300	—	—
Proceeds from exercise of employee stock options	132	—	—
Borrowings of long-term debt	678,003	65,000	62,606
Repayments of long-term debt	(200,233)	(21,322)	(2,331)
Debt issuance costs	(16,445)	(112)	(591)
Net (payments to) advances from Majority Shareholder	(17,047)	(19,069)	26,256
Contribution from Majority Shareholder	—	1,022	28,000
	<hr/>	<hr/>	<hr/>
Net cash provided by financing activities	766,191	25,519	113,940
Net increase (decrease) in cash and cash equivalents	372,879	5,421	(1,553)
	<hr/>	<hr/>	<hr/>
Cash and cash equivalents, beginning of period	6,905	1,484	3,037
	<hr/>	<hr/>	<hr/>
Cash and cash equivalents, end of period	\$ 379,784	\$ 6,905	\$ 1,484
	<hr/>	<hr/>	<hr/>
Supplemental disclosure of cash flow information:			
Cash paid for interest, net	\$ 16,696	\$ 8,825	\$ 3,972
Cash paid for taxes, other than to Majority Shareholder	\$ 244	\$ 160	\$ 725
	<hr/>	<hr/>	<hr/>
Supplemental disclosure of significant non-cash investing and financing activities:			
Accrued capital expenditures	\$ 76,267	\$ 28,000	\$ —
	<hr/>	<hr/>	<hr/>
Capital expenditures financed with equipment credit facility	\$ 22,604	\$ —	\$ —
	<hr/>	<hr/>	<hr/>

See accompanying notes to consolidated financial statements.

**Notes to Consolidated
Financial Statements
Years Ended December 31,
1997, 1996, and 1995**

(1) Organization and Background

Qwest Communications International Inc. (the "Company") was wholly owned by Anschutz Company (the "Majority Shareholder") until June 27, 1997, when the Company issued common stock in an initial public offering ("IPO"). As of December 31, 1997, the Majority Shareholder owns approximately 83.7% of the outstanding common stock of the Company. The Company is the ultimate holding company for the operations of Qwest Communications Corporation and subsidiaries ("Qwest").

The Company is a developer and operator of telecommunications networks and facilities and operates in a single business segment, the telecommunications industry. It principally provides the following services within that industry:

- Telecommunications Services – the Company provides dedicated line and switched services to interexchange carriers and competitive access providers ("Carrier Services") and long distance voice, data, and video services to businesses and consumers ("Commercial Services").

- Network Construction Services – the Company installs fiber-optic communications systems for interexchange carriers, local telephone companies, cable television companies, competitive access providers, and other communications entities, as well as for its own use.

(2) Summary of Significant Accounting Policies

(a) Principles of Consolidation

The accompanying audited consolidated financial statements as of December 31, 1997, and 1996 and for the years ended December 31, 1997, 1996, and 1995 include the accounts of the Company and all majority-owned subsidiaries. Intercompany balances and transactions have been eliminated in consolidation.

(b) Telecommunications Services Revenue

Revenue from telecommunications services is recognized monthly as the services are provided. Amounts billed in advance of the service month are recorded as deferred revenue.

(c) Long-Term Construction Contracts

The Company accounts for long-term construction contracts relating to the development of telecommunications networks using the percentage of completion method. Under the percentage of completion method, progress is generally measured on performance milestones relating to the contract where such milestones fairly reflect progress toward contract completion.

Network construction costs include all direct material and labor costs and those indirect costs related to contract performance. General and administrative costs are charged to expense as incurred. When necessary, the estimated loss on an uncompleted contract is expensed in the period in which it is identified. Contract costs are estimated using allocations of the total cost of constructing the Qwest Network, a coast-to-coast, technologically advanced, fiber-optic telecommunications network (the "Qwest Network"). Revisions to estimated profits on contracts are recognized in the period they become known.

(d) Cash and Cash Equivalents

The Company classifies cash on hand and deposits in banks, including commercial paper, money market accounts, and any other investments with an original maturity of three months or less, that the Company may hold from time to time, as cash and cash equivalents.

(e) Property and Equipment

Property and equipment is stated at cost. Depreciation is computed on a straight-line basis using the estimated useful lives of the assets, commencing when they are available for

service. Leasehold improvements are amortized over the lesser of the useful lives of the assets or the lease term. Expenditures for maintenance and repairs are expensed as incurred. Network construction costs, including interest during construction, are capitalized. Interest capitalized in the years ended December 31, 1997, 1996, and 1995 was approximately \$17.7 million, \$2.4 million, and \$1.9 million, respectively.

The useful lives of property and equipment are as follows:

Facility and leasehold improvements	5 - 25 years or lease term
Communications and construction equipment	3 - 10 years
Fiber and conduit systems	15 - 25 years
Office equipment and furniture	3 - 7 years
Capital leases	lease term

While constructing network systems for customers, the Company may install additional conduit for its own use. This additional conduit is capitalized at the incremental cost of construction. Costs of the initial conduit, fiber, and facilities are allocated to the customer and the Company based upon the number of fibers retained by the Company relative to the total fibers installed, or square footage in the case of facilities.

(f) Impairment of Long-Lived Assets

The Company reviews its long-lived assets for impairment when events or changes in circumstances indicate that the carrying value of such assets may not be recoverable, in

accordance with Statement of Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of* ("SFAS 121"). This review consists of a comparison of the carrying value of the asset with the asset's expected future undiscounted cash flows without interest costs. Estimates of expected future cash flows are to represent management's best estimate based on reasonable and supportable assumptions and projections. If the expected future cash flow exceeds the carrying value of the asset, no impairment is recognized. If the carrying value of the asset exceeds the expected future cash flows, an impairment exists and is measured by the excess of the carrying value over the fair value of the asset. Any impairment provisions recognized are permanent and may not be restored in the future. No impairment expense was recognized in 1997, 1996, or 1995.

(g) Income Taxes

The Company uses the asset and liability method of accounting for income taxes, whereby deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

(h) Intangible and Other Long-Term Assets

Intangible and other long-term assets include debt issuance costs, deferred compensation, goodwill, and acquired intangibles such as customer contracts and non-compete covenants. Such costs are amortized on a straight-line basis over a period ranging from three to fifteen years.

(i) Earnings Per Share

The Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, which requires the presentation of basic earnings per share and, for companies with potentially dilutive securities, such as convertible debt, options and warrants, diluted earnings per share. Basic earnings per share amounts are determined on the basis of the weighted average number of common shares outstanding during the year. Potentially dilutive instruments for the periods prior to the Company's IPO, as defined by Securities and Exchange Commission Staff Accounting Bulletin Number 98, *Earnings Per Share*, were not material and were excluded from the computation of earnings per share. Diluted earnings per share give effect to all potential dilutive common shares that were outstanding during the year.

(j) Stock-Based Compensation

As permitted by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, the Company accounts for compensation expense under the Growth Share Plan and the Equity Incentive Plan in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*.

(k) Management Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(l) Reclassifications

Certain prior year balances have been reclassified to conform with 1997 presentation.

(3) Other Income (Expense)

On March 10, 1997, the Company entered into an agreement with an unrelated third party to terminate certain equipment purchase and telecommunications capacity rights and options of the Company exercisable against the third party for \$9.0 million in cash, which the Company received in 1997 and has recorded as gain on sale of contract rights.

On July 1, 1996, the Company sold its right, title, and interest in certain telecommunications service agreements to an unrelated third party (the "Buyer") for \$5.5 million. During the transition of service agreements to the Buyer, the Company incurred certain facilities costs on behalf of the Buyer, which are reimbursable to the Company. On March 31, 1997, the arrangement relating to the transition services agreements expired and has not yet been renegotiated. A dispute has arisen with respect to reimbursement of these costs and, as a result the Company made a provision of \$2.0 million in the three months ended March 31, 1997. Negotiations with the Buyer are continuing. As of December 31, 1997 and 1996, net amounts of approximately \$5.0 million and \$2.0 million, respectively, were due to the Company for such costs. The Company believes that the receivable balance as of December 31, 1997, is collectible.

(4) Acquisitions

On October 22, 1997, the Company and an unrelated third party consummated an agreement whereby the Company acquired from the third party all of the issued and outstanding shares of capital stock of SuperNet, Inc. ("SNI"), a regional Internet service provider, and the capital stock of SNI issued at the closing of the acquisition, for approximately \$20.0 million in cash, plus acquisition costs. The acquisition was accounted for using the purchase method of accounting. The purchase price was allocated

as follows (in thousands):

Working capital	\$ (1,517)
Property and equipment	2,890
Goodwill	19,200
Other	(423)
	<u>\$ 20,150</u>

The accompanying consolidated statements of operations include the operating results of SNI since October 22, 1997. The following pro forma operating results of the Company and SNI for the

years ended December 31, 1997 and 1996 have been prepared assuming the acquisition had been consummated as of January 1, 1996 (in thousands, except per share amounts):

	1997	1996
Revenue	\$ 702,260	\$ 236,538
Net earnings (loss)	\$ 10,783	\$ (14,226)
Earnings (loss) per share - basic	\$ 0.06	\$ (0.08)
Earnings (loss) per share - diluted	\$ 0.06	\$ (0.08)

(5) Network Construction Services Revenue and Expenses

Costs and billings on uncompleted contracts included in the accompanying consolidated financial statements are as follows (in thousands):

	December 31,	
	1997	1996
Costs incurred on uncompleted contracts	\$ 473,760	\$ 82,840
Estimated earnings	238,191	48,853
	<u>711,951</u>	<u>131,693</u>
Less: billings to date	476,775	131,738
	<u>\$ 235,176</u>	<u>\$ (45)</u>
Costs and estimated earnings in excess of billings	\$ 256,566	\$ 4,989
Billings in excess of costs and estimated earnings	(21,390)	(5,034)
	<u>\$ 235,176</u>	<u>\$ (45)</u>
Revenue the Company expects to realize for work to be performed on the above uncompleted contracts	<u>\$ 506,791</u>	<u>\$ 328,688</u>

The Company has entered into various agreements to provide indefeasible rights of use of multiple fibers along the Qwest Network. Such agreements include contracts with three major customers for an aggregate purchase price of approximately \$1.0 billion. The Company obtained construction performance bonds totaling \$175.0 million which have been guaranteed by the Majority Shareholder. Network Construction Services revenue relating to the contracts with these major customers was approximately \$513.0 million and \$121.0 million in 1997 and 1996, respectively. Progress billings are made upon customers' acceptance of performance milestones. The Company expects to bill and collect all costs and estimated earnings in excess of billings as of December 31, 1997, in 1998.

Although these construction agreements provide for certain penalties if the Company does not complete construction within the time frames specified within the agreements, management does not anticipate that the Company will incur any substantial penalties under these provisions.

(6) Accounts Receivable

Accounts receivable consists of the following (in thousands):

	December 31,	
	1997	1996
Carrier services	\$ 11,833	\$ 9,978
Commercial services	14,095	5,736
Network construction services	37,085	13,751
Due from affiliate	1,804	—
Other	7,189	3,452
	<u>72,006</u>	<u>32,917</u>
Less allowance for doubtful accounts	(4,611)	(3,669)
Accounts receivable, net	<u>\$ 67,395</u>	<u>\$ 29,248</u>

(7) Notes and Other Receivables

In 1994, an unrelated third party entered into a \$45.0 million agreement to purchase a single conduit from the Company. Contract revenue from this agreement was approximately \$3.1 million and \$29.7 million in the years ended December 31, 1996 and 1995, respectively. The Company may be required to pay up to \$13.0 million to the third party in the event of the sale of the Company-owned conduits. The balance of the notes receivable related to the contract was paid subsequent to year end.

(8) Property and Equipment

Property and equipment consists of the following (in thousands):

	December 31,	
	1997	1996
Land	\$ 991	\$ 506
Facility and leasehold improvements	17,910	7,951
Communications and construction equipment	83,313	52,076
Fiber and conduit systems	118,192	42,446
Office equipment and furniture	16,019	6,360
Capital leases	3,778	3,197
Work in progress	417,042	99,915
	<u>657,245</u>	<u>212,451</u>
Less accumulated depreciation and amortization	(42,605)	(25,916)
Property and equipment, net	<u>\$ 614,640</u>	<u>\$ 186,535</u>

(9) Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consists of the following (in thousands):

	December 31,	
	1997	1996
Accounts payable	\$ 80,862	\$ 41,642
Construction accrual	75,543	18,071
Property, sales, and other taxes	33,926	3,582
Capacity service obligation	8,196	3,658
Accrued interest	7,704	707
Right-of-way obligations	34,006	3,290
Other	13,076	9,179
Accounts payable and accrued expenses	<u>\$253,313</u>	<u>\$80,129</u>

(10) Other Liabilities

Other liabilities consists of the following (in thousands):

	December 31,	
	1997	1996
Right-of-way obligations	\$ 39,014	\$ 1,297
Growth share accrual	17,686	9,291
Equipment to be financed	10,756	—
Other	3,020	1,110
Other liabilities	<u>\$ 70,476</u>	<u>\$ 11,698</u>

(11) Right-of-Way Obligations

The Company has easement agreements with railroads and public transportation authorities. The following is a schedule by years of future minimum payments under easement agreements together with the present value of the net minimum payments as of December 31, 1997.

Year ended December 31:

1998	\$ 34,225
1999	4,228
2000	4,228
2001	4,250
2002	6,099
Thereafter	83,788
Total minimum payments	<u>\$ 136,818</u>
Less amount representing interest	<u>(63,798)</u>
Present value of net minimum payments	<u>\$ 73,020</u>

The present value of net minimum payments is included in accounts payable and accrued expenses and other liabilities. (See note 9 – Accounts Payable and Accrued Expenses and note 10 – Other Liabilities.)

In certain limited instances the Company may be obligated to pay costs of relocating certain conduits owned by third parties on approximately 500 miles of railroad rights of way. The majority of such commitments expire in February 2001. The Company has made a provision of approximately \$2.9 million for such costs in 1997.

Pursuant to certain easement agreements, the Company is required to provide easement grantors with communications capacity for their own internal use.

(12) Long-Term Debt

Long-term debt consists of the following (in thousands):

	December 31,	
	1997	1996
9.47% Notes	\$ 356,908	\$ —
10 7/8% Notes	250,000	—
Revolving credit facility	—	60,000
Equipment credit facility	22,604	—
Network credit facility	—	27,077
Equipment loans	—	9,820
Term notes	—	9,416
Capital lease and other obligations	12,962	28,148
Total debt	<u>642,474</u>	<u>134,461</u>
Less current portion	<u>(12,011)</u>	<u>(25,193)</u>
Long-term debt	<u>\$ 630,463</u>	<u>\$ 109,268</u>

In October 1997, the Company issued and sold \$555.9 million in principal amount at maturity of 9.47% Senior Discount Notes, due 2007 (the "9.47% Notes"), generating net proceeds of approximately \$342.1 million, after deducting offering costs which are included in intangible and other long-term assets. The 9.47% Notes will accrete at a rate of 9.47% per

annum, compounded semiannually, to an aggregate principal amount of \$555.9 million by October 15, 2002. The principal amount of the 9.47% Notes is due and payable in full on October 15, 2007. The 9.47% Notes are redeemable at the Company's option, in whole or in part, at any time on or after October 15, 2002, at specified redemption prices. In addition, prior to October 15, 2000, the Company may use the net cash proceeds from certain equity transactions to redeem up to 35% of the 9.47% Notes at specified redemption prices. Cash interest on the 9.47% Notes will not accrue until October 15, 2002, and thereafter will accrue at a rate of 9.47% per annum, and will be payable semiannually in arrears commencing on April 15, 2003 and thereafter on April 15 and October 15 of each year. The Company has the option of commencing the accrual of cash interest on an interest payment date on or after October 15, 2000, in which case the outstanding principal amount at maturity of the 9.47% Notes will, on such interest payment date, be reduced to the then accreted value, and cash interest will be payable thereafter. In February 1998, the Company completed an exchange of the 9.47% Series B Senior Discount Notes (the "9.47% Exchange Notes"), registered under the Securities Act of 1933 (the "Act"), for all of the 9.47% Notes. The 9.47% Exchange Notes are identical in all material respects to the originally issued 9.47% Notes.

In May 1997, the Company entered into a \$90.0 million credit agreement (the "Equipment Credit Facility") with an unrelated third party supplier of transmission electronics equipment (the "Supplier") to fund a portion of certain capital expenditures required to equip the Qwest Network currently under construction. The facility subsequently was assigned by the Supplier to another institution, which assumed the Equipment Credit Facility and currently acts as the agent. Under the Equipment Credit Facility, the Company may borrow up to 75% of

the price of purchased equipment and related engineering and installation services provided by the Supplier, with the purchased equipment and related items serving as collateral for the loans. The Company is committed to purchase from the Supplier a minimum of \$100.0 million of such equipment and services under a separate procurement agreement, which was executed in May 1997. The Company's total remaining commitment under the procurement agreement was approximately \$68.4 million as of December 31, 1997. Principal amounts outstanding under the Equipment Credit Facility will be payable in quarterly installments commencing on June 30, 2000, with full repayment due on March 31, 2004. Borrowings will bear interest at the Company's option at either (i) a floating base rate offered by a designated reference bank plus an applicable margin; or (ii) LIBOR plus an applicable margin.

On March 31, 1997, the Company issued and sold 10 7/8% Senior Notes due 2007 having an aggregate principal amount at maturity of \$250.0 million. The net proceeds of the 10 7/8% Senior Notes were approximately \$242.0 million, after deducting offering costs which are included in intangible and other long-term assets. Interest on the 10 7/8% Senior Notes is payable semiannually in arrears on April 1 and October 1 of each year, commencing October 1, 1997. The 10 7/8% Senior Notes are subject to redemption at the option of the Company, in whole or in part, at any time on or after April 1, 2002, at specified redemption prices. In addition, prior to April 1, 2000, the Company may use the net cash proceeds from certain specified equity transactions to redeem up to 35% of the 10 7/8% Senior Notes at specified redemption prices. In August 1997, the Company completed an exchange of 10 7/8% Series B Senior Notes (the "10 7/8% Notes"), registered under the Act, for all of the 10 7/8% Senior Notes. The 10 7/8%

Notes are identical in all material respects to the originally issued 10 7/8% Senior Notes.

In April 1996, the Company entered into a long-term \$100.0 million revolving credit facility agreement as amended in September 1996 (the "Facility") which was collateralized by shares of common stock owned and pledged by the Majority Shareholder. In October 1997, the Company repaid the outstanding balance and terminated the Facility.

In April 1995, the Company entered into a \$45.0 million customer contract credit facility agreement to finance certain construction projects undertaken at that time. The facility converted to a term loan upon completion of the construction projects in 1996 and 1995 and is now secured by notes receivable issued in connection with these construction projects. The facility bears interest at the Company's option at either (i) the higher of (a) the bank's base rate of interest, or (b) the Federal Funds Rate plus 1/2%; or (ii) LIBOR plus 9/16%. The outstanding balance was repaid in February 1998.

The Company also incurred other indebtedness during the three-year period ended December 31, 1997, including in 1995 and 1996 \$10.0 million in aggregate under five equipment loans and in January 1995 \$12.0 million in aggregate under two term notes, the proceeds of which were used to repay a portion of the advance from the Majority Shareholder used to purchase Qwest Transmission Inc. In addition, the Company had other outstanding indebtedness in 1997 which it had incurred prior to 1995, including amounts payable under a network credit facility and an additional equipment loan. Such indebtedness had a weighted average interest rate of approximately 9% in 1997, and was repaid in the second quarter of 1997 with proceeds from the 10 7/8% Senior Notes.

The indentures for the 10 7/8%, 9.47%, and 8.29% Notes (defined below) contain certain

covenants that, among other things, limit the ability of the Company and certain of its subsidiaries (the "Restricted Subsidiaries") to incur additional indebtedness and issue preferred stock, pay dividends or make other distributions, repurchase capital stock or subordinated indebtedness, create certain liens, enter into certain transactions with affiliates, sell assets of the Company or its Restricted Subsidiaries, issue or sell capital stock of the Company's Restricted Subsidiaries, or enter into certain mergers and consolidations.

The Company leases certain network construction equipment under capital lease agreements. The amortization charge applicable to capital leases is included in depreciation expense. Future minimum payments under capital lease obligations is included in contractual maturities of long-term debt summarized below.

Contractual maturities of long-term debt as of December 31, 1997 are as follows (in thousands):

	<u>1997</u>
Year ended December 31:	
1998	\$ 12,011
1999	622
2000	3,671
2001	5,078
2002	5,877
Thereafter	<u>615,215</u>
	<u>\$ 642,474</u>

The carrying amounts of the Term Loan and the Equipment Credit Facility approximate fair value since the interest rates are variable and reset periodically. The estimated fair values of the 9.47% Notes and the 10 7/8% Notes, each with a carrying value at December 31, 1997 of approximately \$356.9 million and \$250.0 million, respectively, were approximately \$382.2 million and \$283.8 million, respectively, at December 31, 1997, based on current rates offered for debt

of similar terms and maturity.

In January 1998, the Company issued and sold \$450.5 million in principal amount at maturity of 8.29% Senior Discount Notes, due 2008 (the "8.29% Notes"), generating net proceeds of approximately \$299.2 million, after deducting offering costs. The 8.29% Notes will accrete at a rate of 8.29% per annum, compounded semiannually. The principal amount of the 8.29% Notes is due and payable in full on February 1, 2008. The 8.29% Notes are redeemable at the Company's option, in whole or in part, at any time on or after February 1, 2003 at specified redemption prices. In addition, prior to February 1, 2001, the Company may use the net cash proceeds from certain equity transactions to redeem up to 35% of the 8.29% Notes at specified redemption prices. Cash interest on the 8.29% Notes will not accrue until February 1, 2003, and thereafter will accrue at a rate of 8.29% per annum, and will be payable semiannually in arrears commencing on August 1, 2003, and thereafter on February 1 and August 1 of each year. The Company has the option of commencing cash interest on an interest payment date on or after February 1, 2001, in which case the outstanding principal amount at maturity of the 8.29% Notes will, on such interest payment date, be reduced to the then accreted value, and cash interest will be payable on each interest payment date thereafter.

In connection with the sale of the 8.29% Notes, the Company agreed to make an offer to exchange new notes, registered under the Act and with terms identical in all material respects to the 8.29% Notes, for the 8.29% Notes or, alternatively, to file a shelf registration statement under the Act with respect to the 8.29% Notes. If the registration statement for the exchange offer or the shelf registration statement, as applicable, is not declared effective within specified time periods or, after being declared effective, ceases to be effective

or usable for resale of the 8.29% Notes during specified time periods (each a "Registration Default"), additional cash interest will accrue at a rate per annum equal to 0.50% of the principal amount at maturity of the 8.29% Notes during the 90-day period immediately following the occurrence of a Registration

Default and increasing in increments of 0.25% per annum of the principal amount at maturity of the Discount Notes up to a maximum of 2.0% per annum, at the end of each subsequent 90-day period until the Registration Default is cured.

(13) Income Taxes

Income tax expense (benefit) for the years ended December 31, 1997, 1996, and 1995 is as follows (in thousands):

	1997	1996	1995
Current:			
Federal	\$ —	\$ (1,673)	\$ (10,497)
State	108	(438)	—
Total current income tax expense (benefit)	<u>108</u>	<u>(2,111)</u>	<u>(10,497)</u>
Deferred:			
Federal	8,949	(1,123)	(2,839)
State	—	—	—
Total deferred income tax expense (benefit)	<u>8,949</u>	<u>(1,123)</u>	<u>(2,839)</u>
Total income tax expense (benefit)	<u>\$ 9,057</u>	<u>\$ (3,234)</u>	<u>\$ (13,336)</u>

Total income tax expense (benefit) differed from the amounts computed by applying the federal statutory income tax rate (35%) to earnings (loss) before income tax expense (benefit) as a result of the following items for the years ended December 31, 1997, 1996, and 1995 (in thousands):

	1997	1996	1995
Expected income tax expense (benefit)	\$ 8,253	\$ (3,570)	\$ (13,463)
State income taxes, net of federal income tax expense (benefit)	70	(279)	—
Goodwill amortization	306	568	56
Compensation and growth share expenses	345	—	—
Other, net	83	47	71
Total income tax expense (benefit)	<u>\$ 9,057</u>	<u>\$ (3,234)</u>	<u>\$ (13,336)</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at December 31, 1997 and 1996 are as follows (in thousands):

	December 31,	
	1997	1996
Current deferred tax assets (liabilities):		
Allowance for doubtful accounts	\$ 1,130	\$ 1,283
Accrued liabilities	1,219	1,277
Deferred compensation	492	—
	2,841	2,560
Network construction contracts	(25,185)	(2,560)
	\$ (22,344)	\$ —
Long-term deferred tax assets (liabilities):		
Deferred compensation	\$ 6,503	\$ 3,252
Depreciation	4,337	2,205
Accrued liabilities	1,235	—
Net operating loss carryforward	34,773	—
	46,848	5,457
Intangible assets, principally due to differences in basis and amortization	(71)	(112)
Property and equipment	(28,789)	(752)
	(28,860)	(864)
	\$ 17,988	\$ 4,593

The Company has analyzed the sources and expected reversal periods of its deferred tax assets. The Company believes that the tax benefits attributable to deductible temporary differences will be realized by recognition of future taxable amounts. Accordingly, the Company believes a valuation allowance for its federal deferred tax assets is not necessary.

At December 31, 1997, the Company has net operating loss carryforwards for income tax purposes of approximately \$99.4 million which, if not utilized to reduce taxable income in future periods, will expire in 2012.

The Company is included in the consolidated federal income tax return of the Majority Shareholder, which has a July 31 year-end for income tax purposes. There is a tax allocation agreement between the Company and the

Majority Shareholder which encompasses U.S. federal tax consequences. The Company is responsible to the Majority Shareholder to the extent of income taxes for which the Company and its subsidiaries would have been liable if the Company had filed a consolidated federal income tax return, giving effect to any loss or credit carryover belonging to the Company and its subsidiaries from periods after the Effective Date (defined below). The Majority Shareholder would be responsible to the Company to the extent an unused loss or credit can be carried back to an earlier taxable period after the Effective Date.

The tax agreement was amended effective as of January 1, 1997 (the "Effective Date"). Prior to the amendment, the Company was responsible to the Majority Shareholder for its share of the

current consolidated income tax liabilities. The Majority Shareholder was responsible to the Company to the extent that the Company's income tax attributes were utilized by the Majority Shareholder to reduce its consolidated income tax liabilities, subject to certain limitations on net operating loss and credit carryforwards. At December 31, 1996, the income tax benefit receivable from the Majority Shareholder of approximately \$11.1 million was canceled, which resulted in a reduction of additional paid-in capital.

In certain cases, differences may arise between amounts reported in the financial statements under generally accepted accounting principles and the amounts actually payable or receivable under the tax allocation agreement. Those differences are generally reported as adjustments to capital, as in-substance dividends.

(14) Related Party Transactions

(a) Transactions with Majority Shareholder

The Majority Shareholder incurs certain costs on the Company's behalf, including primarily insurance and corporate transportation services, and allocates such costs to the Company based on actual usage. The cost to the Company for such services was approximately \$4.3 million, \$2.1 million, and \$2.5 million in the years ended December 31, 1997, 1996, and 1995, respectively. In addition, accounts receivable from (payable to) the Majority Shareholder are recognized to reflect federal income tax benefits receivable (income taxes payable) pursuant to the tax allocation agreement between the Company and the Majority Shareholder. Advances from the Majority Shareholder of approximately \$19.1 million outstanding at December 31, 1996 were repaid in 1997.

The Company has agreed to indemnify the Majority Shareholder and its subsidiaries against

any costs or losses incurred by them as a result of their providing credit support to the Company (in the form of collateral pledges, guarantees, performance bonds, or otherwise).

(b) Transactions with Other Related Parties

The Company leases its corporate office in Denver, Colorado from an affiliate of the Majority Shareholder. The cost to the Company for such lease was approximately \$1.4 million, \$1.2 million, and \$1.0 million in the years ended December 31, 1997, 1996, and 1995, respectively.

The Majority Shareholder owned approximately 25% of Southern Pacific Rail Corporation and its subsidiaries ("SPRC") at December 31, 1995. In September 1996, SPRC was acquired by Union Pacific Corporation. As a result of this transaction, the Majority Shareholder's ownership was reduced to approximately 5% of Union Pacific Corporation, and SPRC ceased to be a related party. While a related party, the Company provided telecommunications services to SPRC and charged SPRC approximately \$1.5 million and \$3.6 million in the years ended December 31, 1996 and 1995, respectively. Additionally, the Company purchased and has made future commitments relating to right-of-way easements from SPRC and utilizes specialized SPRC personnel and equipment for its construction projects. While a related party, SPRC charged the Company approximately \$3.3 million and \$2.2 million for these services in the years ended December 31, 1996 and 1995, respectively.

(c) Equity Contribution from Majority Shareholder

On November 11, 1996, the former president and chief executive of the Company resigned his position. Upon his resignation, the Majority Shareholder forgave a note receivable from him in the amount of approximately \$1.0 million. This charge was allocated to the Company in 1996 and is included in selling, general and administrative expenses, and additional paid-in capital in the Company's

consolidated financial statements.

(15) Fair Value of Financial Instruments

The carrying amounts of cash, cash equivalents, accounts receivable, accounts payable, and accrued expenses approximate fair value due to the short-term maturities of these assets and liabilities. The carrying amounts of notes and other receivables approximate fair value due to the relatively short period of time between the origination of these instruments and their expected realization. The carrying amount of long-term right-of-way obligation approximates fair value since it is based upon current interest rates of obligations with similar maturities.

(16) Commitments and Contingencies

(a) Network Construction Project

In 1996, the Company commenced construction of the Qwest Network. The Company projects its total remaining cost at December 31, 1997, for completing the construction of the Qwest Network will be approximately \$1.1 billion. This amount includes the Company's remaining commitment through December 31, 1998, to purchase a minimum quantity of materials for approximately \$147.0 million as of December 31, 1997, subject to quality and performance expectations, and contracts for the construction of conduit systems aggregating approximately \$24.7 million.

(b) Network and Telecommunications Capacity Exchanges

The Company enters into agreements to exchange telecommunications capacity rights and to exchange network assets. In 1997, the Company entered into agreements to acquire network assets from unrelated third parties in exchange for certain of the Company's network assets under construction. Title to the network assets will pass to the exchange parties upon completion of construction and consummation of the exchange.

In January 1998, the Company entered

into an agreement to acquire long-term telecommunications capacity rights from an unrelated third party in exchange for long-term telecommunications capacity rights along segments of the Qwest Network under construction. The exchange agreement provides for the payment of cash by either of the parties for any period during the contract term in which a party provides less than the contracted telecommunications capacity. It is anticipated that the Company will make cash payments for a portion of the telecommunications capacity it receives pursuant to the agreement until it completes construction of the Qwest Network. The exchange agreement provides for liquidating damages to be levied against the Company in the event the Company fails to deliver the telecommunications capacity, in accordance with the agreed-upon timetable.

(c) Leases and Telecommunications Service Commitments

The Company leases certain terminal locations and office space under operating lease agreements and has committed to use certain telecommunications capacity services. Future minimum payments under noncancelable operating lease and service commitments as of December 31, 1997, are as follows (in thousands):

Year ended	Capacity service commitments	Operating leases	Total
Dec. 31:			
1998	\$ 3,977	\$ 6,187	\$ 10,164
1999	250	5,113	5,363
2000	—	3,170	3,170
2001	—	2,280	2,280
2002	—	1,950	1,950
Thereafter	—	4,848	4,848
Total minimum payments	\$4,227	\$23,548	\$27,775

Capacity service expenses are included in telecommunications service expenses. Amounts expensed related to capacity service commitments in the years ended December 31, 1997, 1996, and 1995 were approximately \$7.3 million, \$19.0 million, and \$19.6 million, respectively.

Amounts expensed in the years ended December 31, 1997, 1996, and 1995 related to operating leases were approximately \$6.2 million, \$5.0 million, and \$4.6 million, respectively.

(d) Mexico Fiber Purchase Agreement

In July 1997, the Company entered into an agreement with an unrelated third party whereby the Company will receive (i) four dark fibers along a 2,220 kilometer route to be constructed in Mexico by the third party, and (ii) certain construction inventory and value-added tax refunds, totaling approximately \$2.9 million. In exchange for these assets, the third party will receive the stock of the Company's subsidiary, SP Servicios de Mexico S. A. de C. V., and approximately \$6.7 million upon the achievement of certain milestones.

(17) Growth Share Plan

The Company has a Growth Share Plan (the "Plan") for certain of its employees and directors. A "Growth Share" is a unit of value based on the increase in value of the Company over a specified measurement period. All Growth Share grants made through December 31, 1997, have been made based on a beginning Company value that was greater than or equal to the fair value of the Company at the grant date. The total number of Growth Shares is set at 10 million and the maximum presently available for grant under the Plan is 850,000. All participants, except those granted Growth Shares under the October 1996 Plan, vested fully upon completion of the Company's IPO and settlement was made with 2,591,532 common shares, net of amounts relating to tax withholdings of approximately \$21.9 million. Growth Shares granted under the October 1996 Plan vest at the rate of 20% for each full year of

service completed after the grant date subject to risk of forfeiture and are to be settled with the Company's Common Stock. The future compensation expense associated with the remaining shares has been capped at \$11.00 per share, or approximately \$23.4 million, and will be amortized as expense over the remaining approximately 4-year vesting period. At December 31, 1997, approximately \$14.9 million is included in other long-term liabilities related to outstanding Growth Shares. The Company does not presently intend to make any additional Growth Share grants under this plan. Certain triggering events, such as a change in control of the Company, cause immediate vesting of the remaining Growth Shares and would result in accelerated expense recognition of all unamortized compensation. Participants receive their vested portion of the increase in value of the Growth Shares upon a triggering event, which includes the end of a Growth Share performance cycle.

The Company has estimated an increase in value of the Growth Shares during 1997 and has recorded approximately \$73.5 million of additional compensation expense for this plan in the year ended December 31, 1997. Had the Company accounted for compensation under the Growth Share Plan pursuant to the fair value method in Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, the amount of compensation would not have been different from what has been reflected in the accompanying consolidated financial statements.

The following table summarizes Growth Share grants and Growth Shares outstanding:

	<u>Outstanding Growth Shares</u>
December 31, 1994	676,000
1995 grants	11,000
1995 forfeitures	<u>(42,500)</u>
December 31, 1995	644,500
1996 grants	67,500
1996 forfeitures and settlements	<u>(436,600)</u>

	<u>Outstanding Growth Shares, continued</u>
December 31, 1996	275,400
1997 grants	358,050
1997 settlements	<u>(253,950)</u>
December 31, 1997	<u>379,500</u>

The Company estimated an increase in value of the Growth Shares at December 31, 1996, due to the signing of an agreement to provide an indefeasible right of use to a major customer and recorded approximately \$13.1 million of additional compensation expense in 1996, approximately \$6.0 million of which is payable subsequent to December 31, 1997. No expense was recognized in the accompanying consolidated financial statements for the year ended December 31, 1995, as there were no significant compensatory elements in that period.

(18) Capital Stock

On January 20, 1998, the Board of Directors declared a stock dividend of one share for every share outstanding to stockholders of record as of February 2, 1998, to be distributed on February 24, 1998. This dividend was accounted for as a two for one stock split. All share and per share information included in the consolidated financial statements and the notes hereto have been adjusted to give retroactive effect to the change in capitalization.

On May 23, 1997, the Board of Directors approved a change in the Company's capital stock to authorize 400 million shares of \$.01 par value Common Stock (of which 20 million shares are reserved for issuance under the Equity Incentive Plan, 2 million shares are reserved for issuance under the Growth Share Plan, and 8.6 million shares are reserved for issuance upon exercise of warrants, as described below), and 25 million shares of \$.01

par value Preferred Stock. On May 23, 1997, the Board of Directors declared a stock dividend to the existing stockholder of 172,980,000 shares of Common Stock, which was paid immediately prior to the effectiveness of the registration statement on June 23, 1997. This dividend was accounted for as a stock split. The Company completed the IPO of 31,050,000 shares of Common Stock on June 27, 1997, raising net proceeds of approximately \$319.5 million.

Effective May 23, 1997, the Company sold to an affiliate of the Majority Shareholder for \$2.3 million in cash, a warrant to acquire 8.6 million shares of Common Stock at an exercise price of \$14.00 per share, exercisable on May 23, 2000. The warrant is not transferable. Stock issued upon exercise of the warrant will be subject to restrictions on sale or transfer for two years after exercise.

Effective June 23, 1997, the Company adopted the Equity Incentive Plan. This plan permits the grant of non-qualified stock options, incentive stock options, stock appreciation

Stock option transactions during 1997 were as follows:

	Number of options	Weighted average exercise price
Outstanding January 1, 1997	—	—
Granted	13,958,000	\$15.88
Exercised	(12,000)	\$11.00
Outstanding December 31, 1997	13,946,000	\$15.89
Exercisable December 31, 1997	1,340,000	\$11.00

The following table summarizes certain information about the Company's stock options at December 31, 1997:

Range of exercise prices	Number of options outstanding	Weighted average remaining contractual life	Weighted average exercise price
\$ 7.50 – \$11.00	8,654,000	5.6	\$10.80
\$ 14.69 – \$18.06	535,000	9.6	\$15.84
\$ 22.88 – \$24.00	3,100,000	9.7	\$23.15
\$ 25.13 – \$30.19	1,657,000	9.9	\$29.39
\$ 7.50 – \$30.00	<u>13,946,000</u>	7.2	\$15.88

rights, restricted stock, stock units, and other stock grants to key employees of the Company and affiliated companies and key consultants to the Company and affiliated companies who are responsible for the Company's growth and profitability. A maximum of 20 million shares of Common Stock may be subject to awards under the Equity Incentive Plan.

The Company's Compensation Committee (the "Committee") determines the exercise price for each option: however, stock options must have an exercise price that is at least equal to the fairmarket value of the Common Stock on the date the stock option is granted, subject to certain restrictions.

Stock option awards generally vest in equal increments over a five-year period, and awards granted under the Equity Incentive Plan will immediately vest upon any change in control of the Company, as defined, unless provided otherwise by the Committee at the time of grant. Options granted in 1997 have terms ranging from six to ten years.

Compensation expense recognized for grants under the Equity Incentive Plan was not material in 1997. If compensation expense for the Equity Incentive Plan had been determined using the fair value method described in SFAS 123, the Company's net earnings and earnings per share for 1997 would have been reduced to the pro forma amounts shown in the following table (in thousands, except per share information):

Net earnings	<u>1997</u>
As reported	\$14,523
Pro forma	861
Earnings per share – basic	
As reported	0.08
Pro forma	—
Earnings per share – diluted	
As reported	0.07
Pro forma	—

The weighted-average fair value of each option grant is estimated as of the date of grant to be \$7.94 using the Black-Scholes option pricing model, with the following weighted average assumptions: risk-free interest rate of 5.8%, no expected dividend yields, expected option lives of 7.6 years, and expected volatility of 31%.

(19) Earnings (Loss) Per Share

The following is a reconciliation of the denominators of the basic and diluted earnings per share computations (in thousands, except per share information):

	Year Ended December 31		
	1997	1996	1995
Net earnings (loss)	\$ 14,523	\$ (6,967)	\$ (25,131)
Shares:			
Weighted average number of shares outstanding during the period for computing basic earnings per share	190,505	173,000	173,000
Incremental common shares attributable to dilutive securities:			
Common shares issuable for warrants	1,635	—	—
Common shares issuable under stock option plan	1,621	—	—
Common shares issuable for outstanding growth shares	294	—	—
Number of shares as adjusted for purposes of computing diluted earnings per share	194,055	173,000	173,000
Earnings per share – basic	\$ 0.08	\$ (0.04)	\$ (0.15)
Earnings per share – diluted	\$ 0.07	\$ (0.04)	\$ (0.15)

The weighted average number of options to purchase common stock that was excluded from the computation of diluted earnings per share because the exercise price of the option was greater than the average market price of the common stock was 800,000 for 1997.

(20) 401(k) Plan

The Company sponsors a 401(k) Plan (the "Plan") which permits employees to make contributions to the Plan on a pre-tax salary reduction basis in accordance with the Internal Revenue Code. All full-time employees are eligible to participate after one year of service. The Company contributes a base percentage and matches a portion of the voluntary employee contributions. The cost of the Plan charged to

expense was not material in the periods presented in the consolidated financial statements.

(21) Significant Customers

During the years ended December 31, 1997, 1996, and 1995, two or more customers, in aggregate, have accounted for 10% or more of the Company's total revenue in one or more periods, as follows:

	Customer	Customer	Customer	Customer
	A	B	C	D
1997	6%	31%	37%	—
1996	28%	26%	—	4%
1995	7%	—	—	35%

At December 31, 1997 and 1996, one or more of the customers described above have accounted for 10% or more of the Company's combined accounts receivable, net, and costs and estimated earnings in excess of billings, as follows:

	Customer	Customer	Customer
	A	B	C
1997	—	26%	32%
1996	11%	20%	—

(22) Subsequent Events

In January 1998, the Company entered into a merger agreement (the "Merger Agreement") with an unrelated third party non-facilities-based reseller of long distance services. In the Merger, each outstanding share of the third party's Common Stock (including shares of the third party's Common Stock issued upon conversion of its Series I Stock) will be acquired for that many shares of the Qwest's Common Stock having an aggregate market value equal to \$28.5 million, reduced by certain adjustments and limitations to \$26.8 million, and future payments of \$4.0 million. The proposed acquisition is subject to certain closing conditions that include requisite shareholder approval. If consummated, the proposed acquisition will be accounted for using the purchase method of accounting.

Also in January 1998, the Company signed a long-term contract to provide an unrelated third party telecommunications capacity along approximately 10,000 route miles of the Qwest Network (the "Contract"). In consideration, the Company will receive 19.99% of the third party's

common stock and up to \$310.0 million in cash over an extended payment term. There are restrictions on the sale by the Company of the unrelated third party's common stock, and the unrelated third party has the right to repurchase the common stock until the Contract's second anniversary. The Company will also receive monthly operations and maintenance fees over the term of the multi-year Contract. Prior to delivery of the telecommunications capacity and acceptance by the unrelated third party, the unrelated third party has the right to purchase interim capacity from the Company. The total cash consideration under the Contract will be reduced by 60% of the sums paid by the unrelated third party for purchases of interim capacity. Pursuant to the terms of the Contract, the unrelated third party may require the Company to purchase an additional \$10.0 million of its common stock. If the Company fails to complete at least 75% of the unrelated third party's network by the Contract's third anniversary, the unrelated third party may at its option either: (i) accept the completed portion and pay for it on a pro rata basis; or (ii) terminate the Contract and require the Company to return all consideration received.

On March 8, 1998, the Company signed a definitive merger agreement with an unrelated third party communications services provider. The boards of directors of each company have approved the merger. The terms of the merger agreement call for the acquisition of all of the third party's outstanding common shares and the assumption of all of the third party's stock options by the Company. The purchase price of the all-stock transaction is anticipated to be approximately \$4.4 billion. The merger is intended to qualify as a tax-free reorganization and will be accounted for as a purchase.

(23) Selected Consolidated Quarterly Financial Data
(In Thousands, Except per Share Information) (Unaudited)

	1997			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenue	\$ 72,693	\$ 228,673	\$ 188,955	\$ 206,382
Earnings (loss) from operations	(12,644)	(7,098)	19,860	23,363
Net earnings (loss)	(4,776)	(5,612)	12,651	12,260
Earnings (loss) per share - basic	\$ (0.03)	\$ (0.03)	\$ 0.06	\$ 0.06
Earnings (loss) per share - diluted	(0.03)	(0.03)	0.06	0.06

	1996			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenue	\$ 34,632	\$ 50,871	\$ 44,333	\$ 101,160
Earnings (loss) from operations	(14,653)	(2,262)	571	4,330
Net earnings (loss)	(9,979)	(2,376)	3,454	1,934
Earnings (loss) per share - basic	\$ (0.06)	\$ (0.01)	\$ 0.02	\$ 0.01
Earnings (loss) per share - diluted	(0.06)	(0.01)	0.02	0.01

The Company adopted SFAS 128 in the fourth quarter of 1997. All per share information reflected in the selected consolidated quarterly financial data above has been restated.

*The Board of Directors
Qwest Communications International Inc.:*

We have audited the accompanying consolidated balance sheets of Qwest Communications International Inc. and subsidiaries as of December 31, 1997 and 1996, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Qwest Communications International Inc. and subsidiaries as of December 31, 1997 and 1996, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1997, in conformity with generally accepted accounting principles.

Independent Auditors' Report

55



KPMG Peat Marwick LLP
Denver, Colorado
February 24, 1998, except as to note 22,
which is as of March 8, 1998

(a) The Company's Common Stock is listed on the NASDAQ National Market under the trading symbol "QWST."™ As of March 4, 1998 there were 206,677,742 shares of Common Stock issued and outstanding held by 867 stockholders of record.

The following table sets forth, for the periods indicated, the high and low sales prices per share of Common Stock as reported on the NASDAQ National Market (as adjusted to reflect the two-for-one stock split effected on February 24, 1998 as a dividend):

	<u>High</u>	<u>Low</u>
Fiscal 1997:		
First Quarter	N/A	N/A
Second Quarter	N/A	N/A
Third Quarter	\$ 25.50	\$ 13.625
Fourth Quarter	\$ 32.875	\$ 23.75

The Company completed its initial public offering on June 27, 1997. The Registrant has not paid cash dividends on its Common Stock since becoming a public company and does not anticipate paying cash dividends in the foreseeable future. The terms of the Indentures governing its outstanding notes and certain debt instruments of the Company's subsidiaries restrict the Company's ability to pay dividends. Any payment of future dividends will be at the discretion of the Company's Board of Directors and will depend upon, among other things, the Company's earnings, operations, capital requirements, level of indebtedness, financial condition, contractual restrictions, and other relevant factors. (See "Management's Discussion and Analysis of Financial Condition and Results of Operations.")

No equity securities of the registrant were sold by the registrant during the period covered by this report that were not registered under the Securities Act of 1933 and that have not been previously reported on document.

(b) The Company has used approximately \$187.1 million of the \$319.5 million net proceeds from its initial public offering for construction of its fiber-optic telecommunications network with the remaining net proceeds temporarily invested in certain short-term investment grade securities.

Market for the Registrant's Common Stock and Related Shareholder Matters