Z TEL TECHNOLOGIES INC
Form 10-K
March 31, 2003

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(MARK ONE)

|X| ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE YEAR ENDED DECEMBER 31, 2002

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 000-28467

Z-TEL TECHNOLOGIES, INC.
(Exact name of Registrant as specified in its charter)

DELAWARE	59-3501119
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

601 SOUTH HARBOUR ISLAND BOULEVARD, SUITE 220
TAMPA, FLORIDA 33602
(813) 273-6261
(Address, including zip code, and telephone number including area code, of Registrant's principal executive offices)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT: NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: COMMON STOCK, PAR VALUE $.01 PER SHARE, PREFERRED STOCK PURCHASE RIGHTS

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

YES |X| NO [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

The aggregate market value of the Registrant's Common Stock held by non-affiliates of the Registrant on March 26, 2003 (assuming solely for these purposes that only directors, executive officers and beneficial owners of greater than 10% of the Registrant's Common Stock are affiliates), based on the closing price of the Common Stock on the Nasdaq SmallCap Market as of such date, was approximately $36,036,434.

The number of shares of the Registrant's Common Stock outstanding as of March 26, 2003 was approximately 35,268,253.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement relating to its 2003 Annual Meeting of Stockholders, to be filed subsequently, are incorporated by reference into Part III of this Report.

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ITEM 1. BUSINESS

GENERAL

Z-Tel Technologies, Inc. is a communications service provider. We integrate access to local and long distance telephone networks with our own advanced features and operational support systems to provide innovative telecommunications services to consumers, business and other communications companies.

We were incorporated in Delaware in 1998. Our first service offering, launched in the fourth quarter of 1998, was an access card to make long-distance calls from any phone coupled with enhanced features. We launched our first local telephone service offering in New York during June of 1999. We acquired Touch 1 Communications, Inc. and its long distance operations in April 2000. We launched wholesale operations in January 2002.

At the retail level, our goal is offer distinctive services that give our customers powerful tools to simplify busy lifestyles. Our principal retail services are Z-LineHOME(R), Z-LineBUSINESS(R) and Touch 1 Long Distance. Z-LineHOME, our flagship offering, is residential local and long distance telephone service, bundled with enhanced services, including the Personal Communications Center, a suite of our proprietary Internet-accessible and voice-activated features. The Personal Communications Center includes voicemail, "Find Me" call forwarding and our recently introduced Personal Voice Assistant, or "PVA," which utilizes voice-recognition technology so that users can access and use their own secure, online address books with voice commands. We expect that eventually all our enhanced features will be accessed and managed via voice commands so that PVA will supplant the Personal Communications Center. Z-LineBUSINESS is our local, long distance and enhanced communications service designed primarily for small businesses. We began offering Z-LineBUSINESS in January 2002. Touch 1 Long Distance is a residential long distance telephone service.

As of March 25, 2003, we offer Z-LineHOME, in every state but Alaska, Hawaii and Nevada. We have approximately 230,000 Z-LineHOME customers, primarily in areas served by Regional Bell Operating Companies ("Bell operating companies"). We currently offer Z-LineBUSINESS in 46 states. We have approximately 1,500 Z-LineBUSINESS customers, representing approximately 3,000 lines. We offer Touch 1 Long Distance nationwide and have approximately 100,000 Touch 1 Long Distance customers.

At the wholesale level, we provide telephone and enhanced communications services and operational support services to other telephone companies for their use in providing telephone and enhanced communications services to their own end-user customers. Our principal wholesale customers are MCI and Sprint. Sprint became a wholesale customer in February 2003.

Our access to local telephone networks is based upon the Telecommunications Act of 1996 (the "Telecommunications Act") which requires the traditional local telephone companies ("incumbent local exchange carriers" or "ILECs") to provide competing local telephone companies, such as Z-Tel, with access to the individual components of their networks, called "network elements." Pursuant to the Telecommunications Act, the Federal Communications Commission ("FCC") has mandated that incumbent local exchange carriers provide access to a set of unbundled network elements including, among other elements, local loops, switching, transport and signaling. This set of elements is referred to as the "unbundled network element platform" or "UNE-P." Moreover, the FCC has mandated that ILECs must provide the unbundled network element platform at rates based on a forward-looking, total long-run incremental cost methodology. Access to the ILEC network elements at reasonable rates in combination with our proprietary feature systems and operational and support systems enables us to provide cost effective packages of communications services. Our enhanced services platform and our operational support systems, however, have the capability to integrate with cable, Internet, wireless and other communications transport networks.

We have invested heavily in our operational support systems. Our systems are functionally integrated to support the entire customer life cycle including price quotation, order entry and processing, ILEC interaction, customer care, billing and subscriber management. They are scalable vertically

and horizontally and provide us reliable, flexible, low-cost operational capabilities.

SEGMENT FINANCIAL INFORMATION

We utilize two segments for internal reporting purposes: consumer services (for retail services) and wholesale services. Financial information relating to our consumer services segment and our wholesale segment is set forth in Item 7, "Management's

Discussion and Analysis of Financial Condition and results of Operations" and footnote 23 "Segment Reporting" in the "Notes to the Consolidated Financial Statements."

INDUSTRY BACKGROUND

The Telecommunications Act was enacted principally to foster competition in the local telecommunications markets. The Telecommunications Act imposes a variety of duties upon the incumbent local exchange carriers, including the duty to provide other communications companies, like us, with access to their network elements on an unbundled basis at any feasible point. Such access must be at rates and on terms and conditions that are just, reasonable and nondiscriminatory. A network element is a facility or piece of equipment of the local telephone company's network or the features, functions or capabilities such facility or equipment provides. The Telecommunications Act also establishes procedures under which the Bell operating companies are allowed to handle "in-region" long distance calls, that is, calls that originate from within their telephone service areas and terminate outside their service areas. The Bell operating companies were divested by AT&T in 1984 pursuant to court order under which they were prohibited from providing "in-region" long distance telephone service. With the passage of the Telecommunications Act, a Bell operating company can provide such in-region service if it demonstrates to the FCC and state regulatory agencies that it has complied with a 14-point regulatory checklist, including offering interconnection to other communications companies and providing access to its unbundled network elements on terms approved by a state public service commission.

On November 5, 1999, the FCC released an order establishing the list of unbundled network elements that incumbent local exchange carriers nationwide must provide. Taken together, these unbundled network elements comprise the essential facilities, features, functions and capabilities of an incumbent local exchange carrier's network. Under the FCC's order, the incumbent local exchange carriers must allow competing local telephone companies such as Z-Tel to use the unbundled network elements, in an individual or combined fashion, to provide basic local telephone service. Additionally, the ILECs must price the elements using a forward-looking, total long-run incremental cost methodology. Pricing and implementation rules for unbundled network elements in combined service packages or platform offerings that are at least acceptable for market entry have been adopted in multiple states. The prices for the use of individual network components and combined component service packages will nevertheless vary from state to state, as will an individual state's oversight of unbundled network element platform implementation and operation in regard to individual unbundled network elements and elements provided in combinations. As discussed below under "Government Regulation," the FCC recently re-affirmed the availability of unbundled network elements as part of a scheduled triennial review.

SERVICES

We provide telephone services at both the retail and wholesale level. At the retail level our principal services are Z-LineHOME, Z-LineBUSINESS and Touch 1 Long Distance. At the wholesale level, we provide services to other carriers such as MCI and Sprint for their use in providing services to their own end-user customers.

Z-LINEHOME(R)

Z-LineHOME is our flagship service. Z-LineHOME is local residential telephone service bundled with long distance (1+) telephone service, calling card services and enhanced features, including our own proprietary, Internet-accessible voicemail, "Find Me," "Notify Me" and voice-activated services, as well as caller identification, call forwarding, three-way calling, call waiting and speed calling, all for a single flat monthly price. Bell operating company customers switching to Z-LineHOME keep their existing phone numbers. Our "Unlimited Plan" includes unlimited, nationwide, direct-dialed long distance calling toll-free. Our other lower priced plans include a limited number of long distance minutes at no additional charge. We currently offer Z-LineHOME in every state except Alaska, Hawaii and Nevada, in areas served by Bell operating companies or Sprint and areas formerly served by GTE.

Z-LineHOME includes unique Z-Line features, all of which can be accessed and manipulated by telephone or Internet. Our proprietary voicemail enables Z-LineHOME subscribers to retrieve and listen to their voice-mail messages via telephone or the Internet. Our voicemail system also enables users to forward voicemails via e-mail, as attachments. Our "Find-Me" feature forwards an incoming call to as many as three additional numbers. Our "Notify Me" feature notifies the subscriber via e-mail, pager or ICQ Internet Chat (instant messaging) when a new voice mail message arrives. Both Find Me and Notify Me are accessible via the Internet so that users may easily enable, disable or otherwise alter the functions. We recently introduced "Personal Voice Assistant" or "PVA." PVA allows users to store contacts in a virtual address book and then access and utilize that information by voice from any telephone. Users say "call" and the contact's name, "call John Doe," for example, and PVA connects the call. PVA users can also send voice e-mails. Users record a message via telephone and instruct PVA to deliver the message to a contact. PVA then attaches the voice message to an e-mail and sends the e-mail to the contact.

Z-LINEBUSINESS(R)

Z-LineBUSINESS is our complementary service to Z-LineHOME targeted to small businesses (typically having four or fewer lines). Z-LineBUSINESS, like Z-LineHOME, is local telephone service bundled with long distance (1+) telephone service, calling card services and enhanced features, including our proprietary features. Bell operating company customers switching to Z-LineBUSINESS keep their existing phone numbers. Because we offer service in nearly every state, Z-LineBUSINESS is particularly valuable to firms having multiple locations in various states. With us, they deal with only one telephone company. Our rollout of Z-LineBUSINESS is in its infancy. We offer Z-LineBUSINESS in 46 states (excluding Alaska, Connecticut, Hawaii and Nevada) solely in areas served by a Bell operating company.

TOUCH 1 LONG DISTANCE

Touch 1 Long Distance is a usage-based service that allows customers to use us as their primary long distance calling provider to complete their residential long distance (1+) calls. Touch 1 Long Distance is available nationwide, although we are not actively marketing the service. We acquired Touch 1 Communications, Inc. (Touch 1) in April 2000.

WHOLESALE SERVICES

We also offer telephone and enhanced services and operational support services on a wholesale basis to other carriers for their use in providing services to their own retail customers. We have the capability to provide our wholesale customers with a comprehensive package of communications and support services. Among the wholesale services we offer are local exchange telephone services, long distance telephone services, our proprietary enhanced features, enhanced features we acquire from incumbent local exchange carriers, provisioning (i.e. the process by which a telephone company is established as the end-user's primary telephone company), inbound sales, fulfillment, billing, collections and customer care. In most cases we would expect our wholesale customer to utilize its own long distance services in providing services to its customers. In some cases, in lieu of providing services, we may license our technology to other carriers.

On March 20, 2002, we entered into a four-year contract with MCI WORLDCOM Communications, Inc. ("MCI") whereby we agreed to provide local exchange services, enhanced features and operational and support services and licenses to use certain of our proprietary technology, all for MCI's use in providing telecommunications services to residential and small business customers. MCI filed for bankruptcy protection on July 21, 2002. On November 1, 2002, we significantly amended the terms of our agreement to alter the fee structure and to eliminate certain exclusivity provisions. We expect revenue from this relationship to decline during 2003.

On February 4, 2003 we signed a non-exclusive, wholesale services agreement with the Sprint Communications Company L.P. ("Sprint"). The agreement will give Sprint access to our telephone exchange services and our Web-integrated, enhanced communications platform and operational support systems in connection with Sprint's local residential telephone service.

We intend to pursue wholesale relationships with, among others, wireless telephone companies, Internet service providers, cable television operators, electrical utilities and others who have access to large consumer bases and in particular those who have the capability to bundle communication services.

OPERATIONS SUPPORT SYSTEMS

We have invested substantially in our operations systems and support platform, which enables integrated customer ordering and provisioning, customer care and billing functionality throughout the customer lifecycle. Accessing an incumbent local exchange carrier's network requires us to interact with that applicable incumbent local exchange carrier. To facilitate this interaction, we have established, with outside integration and consulting assistance, electronic gateways to the major incumbent local exchange carriers, network element management software, and a standard internal provisioning interface that can handle multiple incumbent local exchange carrier ordering systems. These electronic gateways reduce the number of steps required to provision a customer and consequently reduce the cost and increase the accuracy of our provisioning process. "Provisioning" is the process by which we (or our wholesale customers) are established as the customer's primary local exchange and long distance telephone service provider. In connection with the incumbent local exchange carriers, our systems also support mediation, network administration and revenue assurance. We now have electronic gateways operational in every state except

Alaska, Hawaii and Nevada, solely in Bell operating company service areas. We do not have electronic gateways established in Sprint service areas and areas formerly served by GTE. Our operational support systems are vertically and horizontally scalable.

BUSINESS STRATEGY

Our basic business strategy is to-

- gain and keep new retail customers by offering unique, innovative functionality at competitive prices,
- focus our marketing expenditures by targeting markets that have favorable regulatory and pricing environments,
- minimize the capital expenditures associated with entering new retail markets and expanding our existing retail markets by use of the unbundled network element platform, and
- leverage our existing facilities and infrastructure by establishing wholesale relationships.

CERTAIN ASPECTS UNDERPINNING OUR BUSINESS STRATEGY

Cost-Effective Bundled Local and Long Distance Telephone Service. We provide cost-effective bundled packages of local and long distance telephone services in markets that have favorable regulatory environments for residential competition. Our service packages include our own enhanced features as well as typical enhanced telephone features such as call waiting and caller identification. We typically lease facilities of the existing incumbent local exchange carrier on a forward-looking, long-term incremental cost basis, which enables us to avoid the need to invest significant capital into telephone plant and equipment. As a result, we are able to provide our services without significant up-front expense.

Scalable Platform for New Markets. Our use of the unbundled of network elements platform (i.e. the facilities of the incumbent local exchange carriers) in providing our services allows us to enter new markets quickly without a significant investment in equipment, as regulatory authorities in those markets adopt favorable rules and pricing for unbundled network elements. Moreover, using our telephone and Internet accessible systems, our customers can manage and configure their own enhanced calling features, thus minimizing our need for an expanded customer service infrastructure.

Seamless Integration of Personal Organizational Tools. Our enhanced services platform has been designed to allow users to download their personal directories from a variety of software packages, including Microsoft Outlook. In addition, directories from other personal contact managers can be downloaded into Outlook and then downloaded into our platform.

Advanced Proprietary Technology. We have created an advanced, integrated and proprietary software and network architecture that enables the enhanced features of our service. We have created software applications that can control the basic functions of initiating and completing a telephone call regardless of the access device, such as a telephone, personal computer or personal digital assistant. These applications allow our customers to control

simultaneously all the basic functions of a telephone call using any such device.

Our network architecture is designed to interconnect our main enterprise management center in Tampa, Florida with the switching architecture of the incumbent local exchange carrier. This allows us to provide telecommunications services without the need to collocate network equipment in the central offices of the incumbent local exchange carrier in our target markets and enhances our ability to enter new markets quickly and cost effectively.

We have also developed and enhanced our customer care, billing and provisioning software into one seamlessly integrated package. This integrated package provides us with reliable, flexible, low-cost operational capabilities.

Our network architecture also is designed to accommodate a number of developing technologies, such as telephone calls over Internet protocol, digital subscriber lines, asynchronous transfer mode and coaxial cable systems.

RETAIL MARKETING

We market our retail services to prospective customers primarily through independent sales representatives (including multi-level marketing companies), strategic business relationships, direct mail and traditional advertising media such as billboards, radio and television. We intend to explore the formation of alliances or ventures with other companies, including Internet service providers, cable television companies, electrical utilities, financial institutions, retailers and credit card companies, which we believe will allow us to penetrate efficiently large customer bases with a relatively small capital outlay and to lower customer acquisition costs.

BILLING AND COLLECTION

We have three primary methods for billing and collecting from our customers. For our Z-LineHOME customers, we can (1) direct bill by mail and receive payment through a check or money order by mail; (2) charge a credit card account or (3) set up an automatic withdrawal from a checking account. Currently, we bill the majority of our customers by mail and receive payment through checks delivered by mail. We have a variety of billing arrangements with our wholesale customers.

INTELLECTUAL PROPERTY AND PROPRIETARY RIGHTS

We have developed proprietary software that manages the integrated features of our service offerings and that that allows our network to interface and interconnect with the systems of the incumbent local exchange carriers and long-distance carriers. Our network communication facilities are largely consolidated in our enterprise management center in Tampa, Florida. This consolidation allows us to maximize the productivity and effective management of the facilities.

We have entered into, and will continue to enter into, nondisclosure agreements with our employees, independent contractors, business customers and others. These agreements are intended to protect our confidential and proprietary information, whether or not such information is copyrighted or

subject to trademark or patent protection. We intend to take all appropriate legal action to protect our ownership and the confidentiality of all our proprietary software.

Our intellectual property reflects the know-how, work product and inventions of our research and development team, based at our technology center in Atlanta, Georgia, who have substantial experience in computer technology, telecommunications, web-based services, database management and integration, and network development, architecture, operation and management.

For the fiscal years ended December 31, 2002, 2001 and 2000, we invested approximately $13,157,000, $12,800,000, and $11,361,000, respectively, in company-sponsored research and development activities.

We have filed trademark applications for federal registration of numerous trademarks with the United States Patent and Trademark Office, including, Z-VOICE MAIL, Z-TECHNOLOGY, Z-MAILBOX, Z-NET, and MYZLINE.COM. We have received federal registration of the following trademarks: Z-NODE, Z-LINE, Z-LINEHOME, Z-LINEBUSINESS, WEBDIAL, CLICK & LISTEN, Z-TEL, YOUR PERSONAL COMMUNICATIONS CENTER, Z-TEL COMMUNICATIONS, INC. and design, Z-LINE COMPANION, Z-LINE MESSENGER, Z-TEL and design, and Z-TEL TECHNOLOGIES, INC.

COMPETITION

OVERVIEW

The telecommunications industry is highly competitive in many market segments. However, at present, we believe few telecommunications carriers provide the type of bundled service packages that include the range of services and features that we offer, but various competitors offer one or more of the services that make up our service offerings. Competition in the local telephone services market is still emerging, but already has attracted many competitors. Competition in the long distance and information services markets, which have fewer entry barriers, is already intense and is expected to remain so.

We believe the principal competitive factors affecting our business will be the quality and reliability of our services, innovation, customer service and price. Our ability to compete effectively will depend upon our continued ability to offer innovative, high-quality, market-driven services at prices generally equal to or below those charged by our competitors. Many of our current and potential competitors have far greater financial, marketing, personnel and other resources than we do, as well as other competitive advantages.

LOCAL TELEPHONE SERVICE

Incumbent Local Exchange Carriers. In each of our target markets, we will compete with the incumbent local exchange carrier serving that area, which may be one of the Bell operating companies. As a recent entrant in the telecommunications services industry, we have not achieved and do not expect to achieve in the foreseeable future a significant market share for any of our services in our markets. In particular, the incumbent local exchange carriers have long-standing relationships with their customers, have financial, technical and marketing resources substantially greater than ours, have the potential to subsidize services that compete with

our services with revenue from a variety of other unregulated businesses, and currently benefit from certain existing regulations that favor the incumbent local exchange carriers over us in certain respects.

Recent regulatory initiatives that allow competitive local exchange carriers, such as us, to interconnect with incumbent local exchange carrier facilities and acquire and combine the unbundled network elements of an incumbent local exchange carrier provide increased business opportunities for us. However, such interconnection opportunities have been, and will likely continue to be, accompanied by increased pricing flexibility and relaxation of regulatory oversight for the incumbent local exchange carriers.

Competitive Local Exchange Carriers. The Telecommunications Act radically altered the market opportunity for competitive local exchange carriers. Competitive access providers who entered the market prior to passage of the Telecommunications Act built their own infrastructure to offer exchange access services to large end-users. Since the passage of the Telecommunications Act, many competitive access providers have added switches to become competitive local exchange carriers in order to take advantage of the opening of the local market. With the Telecommunications Act requiring the unbundling of the incumbent local exchange carrier's networks, competitive local exchange carriers will now be able to enter the market more rapidly by leasing switches, trunks and loop capacity until traffic volume justifies building substantial facilities. Newer competitive local exchange carriers, like us, will not have to replicate existing facilities and can be more opportunistic in designing and implementing networks, which could have the effect of increasing competition for local exchange services.

Interexchange Carriers. We also expect to face competition from other current and potential market entrants, including interexchange (long distance) carriers such as AT&T, MCI and Sprint, seeking to enter, reenter or expand entry into the local exchange market. A continuing trend toward consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors.

LONG DISTANCE TELEPHONE SERVICE

The long distance telecommunications industry has numerous entities competing for the same customers and a high average churn rate because customers frequently change long distance providers in response to the offering of lower rates or promotional incentives by competitors. Our primary competitors in the long distance market include major interexchange carriers such as AT&T, MCI and Sprint, certain incumbent local exchange carriers and resellers of long distance services. We believe that pricing levels are a principal competitive factor in providing long distance telephone service. We hope to avoid direct price competition by bundling long distance telephone service with a wide array of value-added, enhanced services.

We believe that incumbent local exchange carriers that offer a package of local, long distance telephone and information services will be particularly strong competitors. Incumbent local exchange carriers, including Verizon, BellSouth and SBC Communications, are currently providing both long distance and local services as well as certain enhanced telephone services that we offer. We believe that the Bell operating companies will attempt to offset market share losses in their local markets by attempting to capture a significant percentage of the long distance market.

ENHANCED SERVICES

We compete with a variety of enhanced service companies. Enhanced services markets are highly competitive, and we expect that competition will

continue to intensify. Our competitors in these markets include Internet service providers, web-based communications service providers and other telecommunications companies, including the major interexchange carriers, incumbent local exchange carriers, competitive local exchange carriers and wireless carriers.

OTHER MARKET ENTRANTS

We may face competition in local, long distance and information services from other market entrants such as electric utilities, cable television companies, fixed and mobile wireless system operators, and operators of private networks built for large end-users. All of these companies are free to offer bundled services similar to those that we offer. Electric utilities have existing assets and low cost access to capital that could allow them to enter a market rapidly and accelerate network development. Cable television companies are also entering the telecommunications market by upgrading their networks with fiber optics and installing facilities to provide fully interactive transmission of broadband voice, video and data communications. Wireless companies have developed, and are deploying in the United States, wireless technology as a substitute for traditional wireline local telephone service. The World Trade Organization agreement on basic telecommunications services could increase the level of competition we face. Under this agreement, the United

States and 68 other member states of the World Trade Organization are committed to open their respective telecommunications markets, including permitting foreign companies to enter into basic telecommunications services markets. This development may increase the number of established foreign-based telecommunications carriers entering and competing in the U.S. markets.

The Telecommunications Act includes provisions that impose certain regulatory requirements on all local exchange carriers, including competitive local exchange carriers. At the same time, the Telecommunications Act expands the FCC's authority to reduce the level of regulation applicable to any or all telecommunications carriers, including incumbent local exchange carriers. The manner in which these provisions are implemented and enforced could have a material adverse effect on our ability to compete successfully against incumbent local exchange carriers and other telecommunications service providers.

WHOLESALE SERVICES

We believe we are the sole competitive local exchange carrier offering local exchange services on a wholesale basis. Our chief competitor on the wholesale level in each territory is the incumbent local exchange carrier, usually a Bell operating company. Our competitive advantage is our knowledge and experience in dealing with incumbent local exchange carriers, our knowledge and experience in offering local services and our proprietary enhanced features. Bell operating companies, in general, do not promote and market their ability to offer wholesale services, preferring to minimize competition in the local telephone services market. We offer our wholesale customers a full suite of services for their use in providing telephone services to their customers. We will face competition from a variety of companies that offer particular services such as provisioning services, billing services and enhanced services (such as voicemail) or that offer technologies related to such services.

GOVERNMENT REGULATION

OVERVIEW

Some of our services are regulated and some are not. In providing our feature services such as voice mail, "Find-Me" call forwarding and Personal Voice Assistant, we operate as an unregulated provider of information services, as that term is defined in the Communications Act of 1934 (the "Communications Act"), as amended by the Telecommunications Act of 1996 (the "Telecommunications Act"), and as an enhanced service provider, as that term is defined in the FCC rules. These non-common carrier operations currently are not regulated by the FCC or the states in which we operate. In providing Z-LineHOME and our long distance services, we are regulated as a common carrier at the state and federal level and are subject to additional rules and policies not applicable to providers of information services alone. We are certificated as a facilities-based competitive local exchange carrier in forty-nine states and the District of Columbia. We are currently seeking such certification in Alaska. Z-Tel is certificated as a long-distance reseller in all fifty states.

The local and long distance telecommunications services we provide are regulated by federal, state, and, to some extent, local government authorities. The FCC has jurisdiction over all telecommunications common carriers to the extent they provide interstate or international communications services. Each state regulatory commission has jurisdiction over the same carriers with respect to providing intrastate communications services. Local governments sometimes seek to impose franchise requirements on telecommunications carriers and regulate construction activities involving public rights-of-way. Changes to the regulations imposed by any of these regulators could have a material adverse effect on our business, operating results and financial condition.

In recent years, the regulation of the telecommunications industry has been in a state of flux as the United States Congress and various state legislatures have passed laws seeking to foster greater competition in telecommunications markets. The FCC and state utility commissions have adopted many new rules and continue to propose additional rules and policies to implement this legislation. These changes, which are still incomplete, have created new opportunities and challenges for us, and our competitors. The following summary of regulatory developments and legislation is intended to describe the most important, but not all, present and proposed federal, state and local regulations and legislation affecting the telecommunications industry. Some of these and other existing federal and state regulations are the subject of judicial proceedings and legislative and administrative proposals that could change, in varying degrees, the manner in which this industry operates. We cannot predict the outcome of any of these proceedings or their impact on the telecommunications industry at this time. Some of these future legislative, regulatory or judicial changes may have a material adverse impact on our business.

Specifically, pursuant to a recent FCC decision in FCC CC Docket No. 01-338 (referred to as the "Triennial Review"), we anticipate that all of the state commissions in which we do business will be reviewing the availability of the unbundled network element platform ("UNE-P") within their states. As described below under "Federal Regulation-FCC Regulation of Common Carrier

Services-Interconnection and Unbundling Requirements," UNE-P is the regulatory framework under which Z-Tel offers local telecommunications services to our customers. The details of these proceedings are unknown at this time because the

FCC has not released the complete text of its decision and this decision will not become legally effective until after that decision is published. However, according to an FCC news release dated February 20, 2003, state commissions will be expected during the next 9 months to engage in a detailed and fact-intensive review of the availability of UNE-P for local telephone services in their states. The results of these state commission proceedings will impact on our business, and restriction in the availability of UNE-P could have a material adverse impact on our business.

Moreover, pursuant to federal standards state commissions, establish the prices we pay for access to network elements. State commissions are continually re-evaluating those prices. As states re-evaluate pricing of network elements, it is possible that some states could increase or lower rates over existing levels. The incumbent local exchange carriers, Verizon, BellSouth, SBC and Qwest, regularly have rate cases pending before state regulatory commissions. There are ongoing rate cases in Florida, Georgia, Illinois, Indiana, Michigan, Pennsylvania, Massachusetts, California, and Texas, among others, and these proceedings could significantly raise or lower the existing rates for some network elements and network element combinations. Our intent is to be an active participant in many of these rate cases and any others that might be critical to our operations. We anticipate joining other competitive service providers in arguing that existing rates and rates proposed by the incumbents are overstated and do not reflect the true total element long run incremental costing principles required by the FCC and the Telecommunications Act. The legality of the FCC-prescribed methodology for calculating unbundled network element rates was affirmed by the United States Supreme Court in Verizon v. FCC on May 13, 2002. In the Triennial Review decision announced on February 20, 2003, the FCC noted that it will clarify two aspects of this federal methodology (referred to as Total Element Long Run Incremental Cost, or TELRIC) related to cost of capital and depreciation of new, advanced telecommunications equipment. Since the text of the FCC's Triennial Review decision has not been released, we cannot analyze the potential impact those clarifications may have upon current or future rates. While the prevailing trends within the industry would predict the adoption of lower rates in association with unbundled network elements and network element combinations, we cannot predict the outcome of any pending or potential rate case or judicial proceeding. We could face an additional series of rate cases before state commissions to respond to the FCC's clarification of its TELRIC rules. Increases or decreases in rate levels charged by incumbent local exchange carriers can result from regulatory or judicial review of a rate case or arbitration proceedings, and such changes could significantly impact our business plans.

FEDERAL REGULATION

FCC POLICY ON ENHANCED AND INFORMATION SERVICES

In 1980, the FCC created a distinction between basic telecommunications services, which it regulates as common carrier services, and enhanced services, which are unregulated. The FCC exempted enhanced service providers from federal regulations governing common carriers, including the obligation to pay access charges for the origination or termination of calls on carrier networks and the obligation to contribute to the universal service fund. The Telecommunications Act of 1996 established a similar distinction between telecommunications services and information services. Changing technology and changing market conditions, however, sometimes make it difficult to discern the boundary between unregulated and regulated services.

In general, information services are value-added services that use regulated transmission facilities only as part of a service package that also includes network or computer software to change or enhance the information transmitted. We believe that most of the feature services we provide, including voice mail, "Find-Me" call forwarding, and Personal Voice Assistant, are

information services under the FCC's definition. Because the regulatory boundaries in this area are somewhat unclear and subject to dispute, however, the FCC could seek to characterize some of these services as "telecommunications services." If that happens, those services would become subject to FCC regulation, although the impact of that reclassification is difficult to predict. In Docket No. 01-337, the FCC has proposed rules that would classify broadband Internet access services offered by wireline telecommunications providers as "information services" under the Communications Act.

In general, the FCC does not regulate the rates, services, and market entry of non-dominant telecommunications carriers, but does require them to contribute to universal service and comply with other regulatory requirements. We are currently regulated as a non-dominant carrier with respect to both our local and long distance telephone services. Typically, the incumbent local exchange carrier is the dominant carrier in connection with local services. AT&T is the traditional dominant carrier in connection with long distance services.

FCC REGULATION OF COMMON CARRIER SERVICES

We currently are not subject to rate of return regulation at the federal level and are not currently required to obtain FCC authorization for the installation, acquisition or operation of our domestic exchange or interexchange network facilities. However, we must comply with the requirements of common carriage under the Communications Act. We are subject to the general requirement that our charges and terms for our telecommunications services be "just and reasonable" and that we not make any "unjust or unreasonable discrimination" in our charges or terms. The FCC has jurisdiction to act upon complaints against any common carrier for failure to comply with its statutory obligations. Our ability to discontinue interstate services is regulated by Section 214 of the Communications Act and FCC implementing rules.

Comprehensive amendments to the Communications Act were made by the Telecommunications Act, which was signed into law on February 8, 1996. The Telecommunications Act effected changes in regulation at both the federal and state levels that impact virtually every segment of the telecommunications industry. The stated purpose of the Telecommunications Act is to promote competition in all areas of telecommunications. While it may take years for the industry to feel the full effects of the Telecommunications Act, it is already clear that the legislation provides us with new opportunities and challenges.

Interconnection and Unbundling Requirements. The Telecommunications Act greatly expands the interconnection requirements applicable to the incumbent local exchange carriers, i.e., generally, those existing local telephone companies that, in the past, enjoyed virtual or legal monopoly status. (Conversely, new entrants to the local telephone market, like Z-Tel, are referred to as "competitive local exchange carriers.") The Telecommunications Act requires the incumbent local exchange carriers to-

- provide physical collocation, that is allow competitive local exchange carriers to install and maintain their own network termination equipment in incumbent local exchange carrier central offices, or, if requested or if physical collocation is demonstrated to be technically infeasible, provide virtual collocation;

- offer components of their local service networks on an

unbundled basis so that other providers of local service can use these elements in their networks to provide a wide range of local services to customers; and

- establish "wholesale" rates for their services to promote resale by competitive local exchange carriers.

In addition, all local exchange carriers must -

- interconnect with the facilities of other carriers;
- establish number portability, that is allow customers to retain their existing phone numbers if they switch from the local exchange carrier to another local service provider;
- provide nondiscriminatory access to telephone poles, ducts, conduits and rights-of-way; and
- compensate other local exchange carriers on a reciprocal basis for traffic originated by one local exchange carrier and terminated by another local exchange carrier.

The FCC is charged with implementing certain portions of the Telecommunications Act, including the unbundling and interconnection requirements, upon which Z-Tel relies to provide local telephone services. The FCC issued its first unbundling and interconnection order on August 8, 1996, referred to as the 1996 Local Competition Order. Among other rules, the 1996 Local Competition Order established a list of seven network elements, comprising most of the significant facilities, features, functionalities, or capabilities of the network, that the incumbent local exchange carriers must unbundle. It is possible for competitors to provide competitive local exchange service using only these unbundled network elements. In addition, the FCC mandated a particular forward looking pricing methodology for these network elements (TELRIC).

Those rules have been the subject of considerable litigation. Two Supreme Court decisions have resolved some of these issues, but many others, including the identification of network elements that must be unbundled, remain in dispute.

In the May 13, 2002 decision in Verizon v. FCC, the Supreme Court affirmed the particular pricing methodology adopted by the FCC in the 1996 Local Competition Order for unbundled network elements, known as TELRIC. That decision ensures that unbundled elements must be priced according to forward-looking costs, at least until the FCC changes its pricing methodology. On

February 20, 2003, an FCC news release indicates that a future FCC order will clarify two aspects of this pricing methodology with regard to cost of capital and depreciation and new network investment. The text of that "clarification" has not been released; however, we anticipate that this clarification may result in reassessment of unbundling rates by many states, which could impact our business. In addition, the FCC's Calendar Year 2003 Strategic Plan notes that it is considering a complete review of its TELRIC rules. The FCC has not released any proposals to modify those rules, but implementation of a different or modified pricing standard for unbundled network elements could significantly impact our business.

On January 25, 1999, in AT&T v. Iowa Utilities Board, the Supreme Court held that the FCC has general jurisdiction to implement the local competition provisions of the Telecommunications Act. In so doing, the Supreme Court stated that the FCC has authority to set pricing guidelines for unbundled network elements, to prevent incumbent local exchange carriers from physically separating existing combinations of network elements, and to establish "pick and choose" rules regarding interconnection agreements. "Pick and choose" rules would permit a carrier seeking interconnection to pick and choose among the terms of service from other interconnection agreements between the incumbent local exchange carriers and other competitive local exchange carriers. This 1997 Supreme Court decision reversed a July 18, 1997 decision by the United States Court of Appeals for the Eighth Circuit on many grounds.

In part of this 1999 AT&T decision, the Supreme Court remanded the list of unbundled network elements identified in the 1996 Local Competition Order to the FCC for further consideration of the necessity of each one under the Telecommunications Act's statutory standard for unbundling. In response to this Supreme Court decision, on November 5, 1999, the FCC released an order (the "1999 Unbundling Order") that largely retained the existing list of unbundled network elements, but eliminated the requirement that incumbent local exchange carriers provide unbundled access to operator services and directory assistance and limited unbundled access to local switching. With regard to operator services and directory assistance, the FCC concluded that the market has developed since 1996 such that competitors can and do provide these services, or acquire them from alternative sources. The FCC also noted that incumbent local exchange carriers remain obligated under the non-discrimination requirements of the Communications Act of 1934 to comply with the reasonable request of a carrier that purchases these services from the incumbent local exchange carriers to rebrand or unbrand those services, and to provide directory assistance listings and updates in daily electronic batch files. With regard to unbundled local switching, the FCC concluded that, notwithstanding the incumbent local exchange carriers' general duty to provide unbundled local circuit switching, an incumbent local exchange carrier is not required to unbundle local circuit switching for competitors for end-users with four or more voice grade (DSO) equivalents or lines, provided that the incumbent local exchange carrier provides nondiscriminatory access to combinations of unbundled loops and transport (also known as the Enhanced Extended Link) throughout Density Zone 1, and the incumbent local exchange carrier's local circuit switches are located in (i) the top 50 Metropolitan Statistical Areas as set forth in Appendix B of the Third Report and Order and Fourth Further Notice of Proposed Rulemaking in FCC Docket No. 96-98, and (ii) in Density Zone 1, as defined in the FCC's rules. For operator services and directory assistance, as well as for unbundled local switching, the FCC noted that the competitive checklist contained in Section 271 of the Communications Act requires Bell operating companies to provide nondiscriminatory access to these services. The 1999 Unbundling Order required that Bell operating companies must continue to provide these services to competitors; however, it allowed them to charge different rates for these offerings.

On May 24, 2002, the D.C. Circuit Court of Appeals in USTA v. FCC, reversed and remanded the 1999 Unbundling Order. A subsequent decision by the D.C. Circuit in Competitive Telecommunications Ass'n v. FCC (October 25, 2002) indicated that the FCC may limit required unbundling by means of carrier and service-specific restrictions. In the USTA decision, the D.C. Circuit court decided that the FCC had not adequately examined in specific detail local competitive market conditions, alternative sources of supply, and the impact those local conditions should have on the availability of unbundled network elements. The D.C. Circuit stated that since the FCC had implemented unbundling requirements of "unvarying scope" those rules must be reversed and remanded. In the same decision D.C. Circuit also reversed and vacated the FCC's 1999 Line Sharing and 2000 Line Splitting Orders on similar grounds. (Line Sharing and

Line Splitting are discussed below.) Several competitive carriers have requested a Supreme Court review of the USTA decision, noting in part that the decision is inconsistent with the Supreme Court's rationale in Verizon v. FCC and other grounds. As of March 26, 2003, the Supreme Court has not decided whether to hear that appeal.

On February 20, 2003, the FCC announced its decision in the Triennial Review docket, CC 01-338, a proceeding that it began on December 20, 2001. The final text of this decision has not been released; as a result, we cannot fully determine the impact the decision will have upon our business. However, an FCC press release issued on February 20, 2003 indicates that in this decision the FCC attempted to address the concerns expressed by the D.C. Circuit in the USTA decision. (The effective date of the D.C. Circuit's mandate in USTA was extended to February 20, 2003, which was the date upon which the FCC announced its Triennial Review decision.) In particular, the FCC release states that in order to provide the fact-based, local-market condition requirements imposed by USTA, the FCC decided to request that state commissions undertake an important fact-finding role with regard to

unbundled local switching and dedicated transport. According to the FCC release, with regard unbundled switching in particular (a key component of UNE-P) the FCC established "presumptions" of availability based upon customer characteristics. Parties may attempt to rebut those presumptions before state commissions by arguing with regard to operational or economic factors surrounding the availability of switching from non-incumbent sources in that state for that particular market. With regard to the services Z-Tel seeks to offer, the FCC news release states that the FCC has established a presumption in favor of statewide availability; such presumption may be rebutted in state proceedings that are to last nine months. The FCC rejected arguments that unbundled loops, switching, transport, and signaling at TELRIC rates are required by Section 271 of the Telecommunications Act.

As a result of the Triennial Review proceeding, we anticipate that virtually all states in which we do business will, after the effective date of the to-be-released final FCC Order, commence in the next several months' proceedings about the availability of UNE-P in their jurisdictions. We will participate in many of theses state proceedings, either individually or through coalitions of other similarly situated competitive carriers. We devoted substantial resources in 2001-2002 to building the substantive case that we intend to use in these state proceedings; however, it is impossible to predict the outcome of these proceedings. It is possible that in many states, our ability to utilize UNE-P to serve our customers will be significantly or substantially curtailed. Such a result could significantly, adversely, and materially harm our business. It is also possible that as a result of these cases, our access to UNE-P could be expanded, such as lifting of the 3-line rule in the 1999 Unbundling Order that limits our entry in one or many states. Such a result could assist our small business and wholesale product lines in those states.

The Triennial Review release also indicates that the FCC will significantly loosen its unbundling requirements for "advanced" telecommunications network elements, such as packet-switching technology and other new investment by incumbents. In addition, the FCC eliminated the requirement that incumbents line-share with competitive DSL providers. However, the FCC does appear to have preserved line-splitting, which would allow a Z-Tel customer to obtain competitive DSL service from a non-incumbent suppliers. Once

again, the details of these regulatory changes remain in flux; as a result, it is difficult for us to say how they will impact our business. Many of these changes could substantially harm potential wholesale competitive carrier customers of Z-Tel and therefore could harm our wholesale business. Substantial relaxation of broadband regulations on our incumbent competitors like SBC, Verizon, Qwest and BellSouth could make competition more difficult; for example, incumbents may be able to bundle now-deregulated advanced services with local telephone service, and Z-Tel may not be able to match because we cannot obtain unbundled access to those advanced services. Such a result, among others, could substantially harm our business. In addition, restrictions on unbundled access may limit our business opportunities or ability to expand the services we offer to customers.

We emphasize that the final text of the FCC's Triennial Review decision has not been released as of this writing. As a result, it is impossible to fully gauge the impact the FCC's final Order will have upon Z-Tel's business. Several incumbent local exchange carriers have stated publicly that they intend to appeal that order, and even possibly seek a stay of its implementation. The impact of such a stay upon Z-Tel's business is unclear. If a stay is granted, incumbents may utilize the situation that since the USTA court decision became effective on February 20, 2003, there are no federal rules requiring the unbundling of any network element. Such a result would significantly and substantially harm our business. While we disagree and would certainly litigate that issue, we believe that our current interconnection agreements and contracts with incumbent local telephone companies generally require them to continue to provide us access until new rules are implemented. However, we cannot be certain that our interpretation of our agreements would be accepted by all regulatory or judicial bodies. There are likely to be several other appeals of the FCC's Triennial Review Order which are likely to take at least one to two years to resolve.

The FCC is also considering other changes to other competition rules that could impact our business. On December 20, 2001, the FCC issued a Notice of Proposed Rulemaking in CC Docket No. 01-337 in which the FCC sought comment on regulatory requirements for incumbent local exchange carrier provision of broadband telecommunications services. In this proceeding, the FCC is considering whether it should remove regulatory safeguards and common carrier obligations, including unbundling regulations, on incumbent local exchange carrier broadband networks. An FCC decision limiting unbundling or deregulating incumbent local exchange carrier broadband networks could have a significant and material adverse impact on our business. For example, incumbent local exchange carriers may be able to offer consumers deregulated broadband network packages of local exchange, information services and broadband service (such as DSL) that Z-Tel would not be able to offer because Z-Tel would not have unbundled access to that broadband network. In addition, because the incumbent local exchange carrier "broadband network" in most instances utilizes the same network facilities as the current incumbent local exchange dial tone network, limitations on unbundling or deregulation of that "broadband network" could inexorably make it difficult, more costly, or even impossible, for Z-Tel to provide its current telecommunications and information services to consumers.

On February 14, 2002, the FCC adopted a Notice of Proposed Rulemaking in CC Docket No. 02-42 that proposed to classify incumbent local exchange carrier provision of wireline broadband Internet access services as an "information service" and regulate the

provision of such services pursuant to Title I of the Communications Act of 1934. In addition, the FCC sought comment on whether its Computer II/Computer III rules, which govern access to incumbent networks by third parties to provide information services. The proposed rules could, if adopted without adequate assurances for competitive access, limit the ability of new entrants to access and utilize the networks of incumbent local exchange carriers to provide advanced, broadband Internet access and could therefore harm Z-Tel's ability to provide services to its customers.

These and other FCC determinations are likely to be the subject of further appeals or reconsideration. Thus, while the Supreme Court has resolved many issues, including aspects of the FCC's jurisdictional authority, other issues remain subject to further consideration by the courts and the FCC. We cannot predict the ultimate disposition of these matters and their impact on our business.

Interconnection Agreements. The Telecommunications Act obligates incumbent local exchange carriers to negotiate with us in good faith to enter into interconnection agreements. Competitive local exchange carriers like us can purchase unbundled network elements under such an agreement or under a tariff or a Statement of Generally Available Terms filed with the state regulators. Interconnection agreements are a prerequisite to obtaining access to the incumbent local exchange carrier's unbundled network elements and to provide the connectivity to our network necessary to provision local exchange services, including Z-LineHOME. Z-Tel operates from interconnection agreements in the following SBC states: California, Texas, Arkansas, Missouri, Kansas, Oklahoma, Illinois, Indiana, and Ohio. SBC and Z-Tel have signed interconnection agreements in Michigan and Wisconsin and are awaiting approval from those state commissions. Meanwhile, Z-Tel continues to purchase required network elements from SBC Ameritech's state tariffs in Michigan and Wisconsin. (Z-Tel does not currently operate in SBC's territory in Connecticut and Nevada.) Z-Tel has effective interconnection agreements, approved by the relevant state commissions, in all the states where in which Verizon, Qwest and BellSouth are an incumbent local exchange carrier. In addition, Z-Tel has effective interconnection agreements, approved by the relevant state commissions, with Sprint in Florida and Nevada.

To ensure that it obtains interconnection and unbundled access at the best-available terms, Z-Tel reviews available contracts, or amendments, and negotiates new arrangements in a number of states. Section 252(i) of the 1996 Act gives Z-Tel the legal right to "pick-and-choose" interconnection and unbundling terms and conditions in this manner. However, in a February 20, 2003 release, the FCC proposed to eliminate many, if not all, of these "pick-and-choose" requirements. The text of this FCC proposal has not yet been released, so we cannot say how implementation of the proposal may have on our business. However, limitations on our ability to pick-and-choose interconnection and unbundling terms and conditions could have a significant adverse impact on our business, by increasing our costs in reaching interconnection agreements and possibly having less-favorable arrangements than our competitors. In addition, at any point in time our interconnection agreement may not contain the best-available terms offered to our competitors, a situation that could adversely affect our ability to compete in the market.

If we cannot reach a voluntary interconnection agreement with an incumbent local exchange carrier on acceptable terms, either side may petition the applicable state commission to arbitrate remaining disagreements. These arbitration proceedings can last for a substantial period of time and can require substantial resources to litigate. Moreover, state commission approval of any interconnection agreement resulting from negotiation or arbitration is required, and any party may appeal an adverse decision by the state commission to federal district court. The incentive of the incumbent local exchange carrier to negotiate fair or proper interconnection agreement terms is a function of the

willingness and authority of state commissions and the FCC to enforce rules and policies promulgated under the Telecommunications Act. The potential cost in resources and delay from this interconnection agreement negotiation and arbitration process could harm our ability to compete in certain markets, and there is no guarantee that a state commission would resolve disputes, including pricing disputes, in our favor.

The ability of a new entrant like Z-Tel to enforce interconnection agreements and state tariffs with incumbent local exchange carriers or appeal state commission arbitrations regarding interconnection agreements is currently subject to considerable legal uncertainty. In May 20, 2002, the United States Supreme Court in Verizon v. Maryland PSC decided that it was appropriate for carriers to appeal state commission determinations to enforce interconnection agreements in federal district court. State commissions had argued that the Eleventh Amendment precludes appeal of these decisions and determinations to federal district court, and the Supreme Court's decision resolved many such questions. Nevertheless, the relationship the interconnection and unbundling implementation provisions of the 1996 Act and state law remain subject to considerable litigation. A January 2002 decision by the United States Circuit Court for the Eleventh Circuit ruled that the Georgia state commission did not have authority to enforce interconnection agreements between incumbent local exchange carriers and new entrants. This decision is in apparent conflict with decisions by other United States Circuit Courts. As a result of this decision, litigating enforcement of interconnection agreements in state or federal courts in the Eleventh Circuit and elsewhere could substantially increase the cost of such litigation. In addition, two recent decisions by the United States Circuit Court of Appeals for the Sixth Circuit indicate that the authority of the Michigan state commission to require incumbent local telephone companies to file unbundling and interconnection tariffs may be limited or even

preempted by the 1996 Act interconnection agreement process. In Michigan and other states, Z-Tel has utilized rights under state tariff regimes to provide service; limitations on our ability to utilize Michigan or other state tariffs in this way could increase our costs of doing business significantly. Moreover, limitations on the ability to resort to state laws, regulations, policies, or procedures could made entry into local markets more costly, time-consuming, and difficult.

Collocation. The FCC has adopted rules designed to make it easier and less expensive for competitive local exchange carriers to collocate equipment at incumbent local exchange carriers' central offices by, among other things, restricting the incumbent local exchange carriers' ability to prevent certain types of equipment from being collocated and requiring incumbent local exchange carriers to offer alternative collocation arrangements. Restrictions and impediments to collocation could harm our business as they make it more difficult if not impossible for us to obtain alternatives to unbundled network elements we purchase from incumbent local exchange carriers.

As outlined in our previous annual reports, the FCC's collocation rules have been subject to a number of legal challenges by incumbent local telephone companies. On June 18, 2002, the D.C. Circuit affirmed the legality of the FCC's collocation rules in Verizon Telephone Companies v. FCC. In the process of these court challenges, the FCC's new rules could increase the cost and time for competitors to collocate equipment in incumbent local exchange carrier central offices and could have a substantial and material impact on Z-Tel's future business prospects.

Line Sharing and Line Splitting. In November 1999, the FCC adopted an order that required incumbent local exchange carriers to provide line sharing, which is a method in which a competitive provider can provide data services over the same line that the incumbent provides voice services (the 1999 Line Sharing Order). In an order on reconsideration, the FCC stated that incumbents must also permit competitive carriers to engage in "line-splitting" arrangements in which one competitive provider may offer voice services and another competitive provider may offer data services (e.g., DSL) on one of the incumbent's local loops (the 2000 Line Splitting Order). In USTA, the D.C. Circuit reversed, remanded and vacated the 1999 Line Sharing Order and 2000 Line Splitting Order.

On February 20, 2003, as part of its Triennial Review decision discussed above, the FCC announced that it will eliminate the requirement that line-sharing be provided as an unbundled network element, subject to a transition period. Z-Tel does not utilize line-sharing to provide DSL services to our customers, so we believe that the FCC February 20, 2003 announcement that its Triennial Review Order will eliminate line-sharing as an unbundled network element has no immediate impact on our retail business. However, since the text of that Order had not been released, we cannot now predict how that decision could impact future prospects of our business, the on-going viability of our wholesale or potential wholesale customers that may utilize line-sharing. The FCC's Triennial Review release does indicate that the FCC has kept in place requirements for "line-splitting," which is the method in which a Z-Tel voice customer may be able to order DSL service from a non-incumbent competitor. Once again, since the text of the FCC decision has not been released, we cannot at this time make any judgment as to the impact that decision would have on our business.

While we expect that the preservation of line-splitting could be beneficial to competitive local exchange carriers like Z-Tel, we cannot be certain that these rules will be implemented by the incumbent local exchange carrier in a timely or favorable manner. As a result, Z-Tel's ability to offer its customers DSL service and voice service by use of line-splitting and the unbundled network element platform combination is restricted significantly by incumbent local exchange carriers. That restriction could harm our business and our ability to match the service packages and bundles offered by our competitors, including the incumbents. In addition, the FCC's apparent elimination of line-sharing could make existing and potential wholesale competitive carrier customers less-financially viable, which could harm our business.

Bell Operating Company Entry into the Long Distance Market. The Telecommunications Act permitted the Bell operating companies (Verizon, SBC, Qwest, and BellSouth) to provide long distance services outside their local service regions immediately, and permits them to provide in-region long distance service upon demonstrating to the FCC that they have adhered to the Telecommunication Act's Section 271 14-point competitive checklist. The FCC must also find that granting the application would be in the "public interest."

Bell operating companies typically seek approval from state public utility commissions prior to filing an application for Section 271 relief before the FCC. To date, some states have denied these applications while others have approved them. The Bell operating company can file an application with the FCC for Section 271 relief regardless of the outcome of the state's review. Based on its own review as well as recommendations from the United States Department of Justice and the involved state public utility commission, the FCC then either approves or denies the application.

Prior to December 1999, the FCC had denied each of the Bell operating company applications brought before it because it found that the particular Bell operating company had not sufficiently made its local network available to competitors. However, since December 1999, the FCC has not rejected a Section 271 application submitted by any Bell operating company, although several applications have been withdrawn after being submitted. In late December 1999, the FCC approved Verizon's Section 271 application for the state of New York. Since that time, the FCC has approved Bell operating company applications in 36 other states and the District of Columbia. Section 271 authority has been granted in Currently pending before the FCC are applications for Michigan (SBC), Nevada (SBC), New Mexico (Qwest), Oregon (Qwest), and South Dakota (Qwest). In addition to those pending applications, Bell operating companies do not have Section 271 authority in Illinois, Indiana, Ohio, Wisconsin, Minnesota, and Arizona.

Several state public utility commissions (including Illinois and Minnesota) have proceedings underway in association with anticipated Section 271 applications. While we cannot predict the outcome of any Section 271 applications before the FCC or any individual state, we expect Bell operating companies to file applications for long distance authority in most of the remaining states in 2003 and that the FCC will grant many, if not most, of those applications, despite the objections of competitive carriers and the Department of Justice.

It is generally expected that competition for Z-Tel's long-distance services will increase as the Bell operating companies enter the market. Section 271 entry permits the Bell operating company to offer a bundle of local, long-distance and enhanced services comparable to Z-Tel's services and therefore could increase competition and harm our business, especially if we cannot obtain adequate access to unbundled network elements from that same Bell operating company.

The Section 271 process also provides an important incentive for Bell operating companies to comply with the unbundling and interconnection requirements of the Telecommunications Act. Z-Tel relies upon obtaining unbundled access and interconnection with Bell operating companies to provide its services to its customers; as a result, Z-Tel has a direct business interest in ensuring that the Bell operating companies comply with the law. Granting a Bell operating company long-distance authority pursuant to Section 271 in a state where the Bell operating company has not fully-complied with the law could have a significant and material adverse impact on Z-Tel's business, as it would diminish the incentive of Bell operating companies to comply with the law nationwide. Z-Tel has in many cases documented discriminatory behavior by the Bell operating company. For example, on September 19, 2001, the FCC granted Verizon's Section 271 application for Pennsylvania, despite the strong objections of Z-Tel and other competitors that Verizon's operational systems in that state were discriminatory. In October 2001, Z-Tel appealed that FCC decision before the United States Circuit Court for the District of Columbia. That appeal was heard by the D.C. Circuit in February 2003 and a decision is pending. If Z-Tel is not successful in this litigation, the incentive of Bell operating companies to comply with their interconnection and unbundling obligations fully could be significantly diminished, which could have a material adverse impact on our business.

The D.C. Circuit has recently reversed FCC 271 grants on the basis that the FCC did not consider all the evidence and arguments before it. In December 28, 2001, the United States Circuit Court for the District of Columbia remanded the FCC's decision to grant SBC long-distance authority in Kansas and Oklahoma. On October 22, 2002, the D.C. Circuit reversed the FCC's Massachusetts 271 Order

in WorldCom v. FCC. In both decisions, the court ruled that the FCC had not fully considered whether granting such authority was in the public interest, given the alleged potential for a "price squeeze" between regulated retail and wholesale rates for local service. These proceedings have been remanded to the FCC. It is unclear how and when the FCC will decide this issue on remand. If the FCC continues to reject arguments raised by competitors, the ability for entrants to utilize the section 271 process as a method of achieving lawful wholesale rates or compliance with the 1996 Act could be substantially diminished.

Universal Service. In May 1997, the FCC released an order establishing a significantly expanded universal service regime to subsidize the cost of telecommunications service to high cost areas, as well as to low-income customers and qualifying schools, libraries and rural health care providers. Providers of interstate telecommunications services, like us, as well as certain other entities, must pay for these programs. We are also eligible to receive funding from these programs if we meet certain requirements. Our share of the payments into these subsidy funds is based on our share of certain defined interstate telecommunications end-user revenues. Currently, the FCC is assessing such payments on the basis of a provider's revenue, and the FCC adjusts payment requirements and levels periodically. Various states are also in the process of implementing their own universal service programs. We are currently unable to quantify the amount of subsidy payments that we will be required to make to individual states.

On July 30, 1999, in Texas Office of Public Utility Counsel v. FCC, the Fifth Circuit overturned certain of the FCC's rules governing the basis on which the FCC collects subsidy payments from telecommunications carriers and recovery of those payments by incumbent local exchange carriers. The Fifth Circuit ruled that the FCC's could not require that incumbent local exchange carriers recover universal service costs via access charges paid by interstate carriers, as such a result would create an implicit subsidy prohibited by section 253 of the 1996 Act. In October 1999, on remand from this decision, the FCC issued new universal service

rules. The FCC decided that if a carrier derives less than 8 percent of its revenue from interstate services, its international revenues will not be used in calculating the contribution. For those carriers receiving 8 percent or more of their revenues from interstate services, the FCC will include their international revenue in the base for determining their contributions. The Commission also permitted, rather than require, ILECs to recover their universal service costs through access charges to interstate carriers. These or other changes to the universal service program could affect our costs by increasing charges for interstate access or requiring higher assessments on interstate revenues. On May 20, 2001, the Fifth Circuit once again reversed the FCC's rules, deciding, in Comsat Corp. v. FCC, that the FCC cannot permit local exchange carriers to recover universal service charges through access charges, as such an arrangement would create an implicit subsidy.

On December 13, 2002, the FCC announced that it will modify on an interim basis the method in which carriers are required to make payments to the fund. Among other changes, the FCC announced that carriers will be required to contribute based upon projected, collected end-user interstate revenues, instead of historical, gross-billed revenues. Competitive carriers will be prohibited from marking-up USF contributions for administrative fees if carriers recover USF contributions through phone bill line items. These interim measures impact

the manner in which we make contributions into the federal fund and could impact our business. The FCC also proposed further changes to its contribution methodology.

The outcome of this litigation and subsequent and forthcoming FCC and state determinations could adversely impact or delay our ability to obtain universal service funding for our services, the sums we pay into universal service funds, the price for access, and our ability to compete with carriers that do obtain such funding. Changes to the federal or state support programs could adversely affect our costs, our ability to separately-list these charges on end-user bills, and our ability to collect these fees from our customers.

Interstate Tariffs and Rates. Beginning July 31, 2001, interstate domestic long distance companies were no longer allowed to file interstate long-distance end-user tariffs with the FCC. This regulatory change requires that Z-Tel must make its long-distance service information directly available to customers pursuant to private contracts. In March 1999, the FCC adopted rules that require interexchange carriers like Z-Tel to make specific disclosures on their web sites of their rates, terms and conditions for domestic interstate services. These detariffing and disclosure requirements could increase our costs in providing interstate long-distance services to our subscribers.

On April 27, 2001, the FCC limited the ability of nondominant, competitive local exchange carriers, including Z-Tel, to file tariffs for interstate switched access services. In doing so, the FCC effectively regulates the rates Z-Tel charges long-distance companies for interstate switched access services. Local exchange carriers (like Z-Tel) provide interstate switched access services to interexchange long-distance companies (like AT&T, MCI, and Sprint) when a state-to-state long distance call is made to or placed by a local telephone customer. Given the large number of interstate long-distance companies, these interstate switched access services are provided generally through FCC interstate tariffs. Prior to this April 27, 2001 decision, the FCC had refrained from any price regulation of the interstate access rates of competitive local exchange companies like Z-Tel. With the April 27, 2001 Report and Order in CC Docket No. 96-262, the FCC ruled that it would not accept for filing any interstate switched access tariff filing by a competitive local exchange carriers if the per-minute rate exceeded an FCC benchmark. The FCC benchmark varies by metropolitan statistical area. In metropolitan statistical areas ("MSAs") that a competitive local exchange carrier began to provide service after June 20, 2001 (the effective date of the Order), the FCC benchmark rate is the interstate switched access rate for the "competing" incumbent local exchange carrier, which is established pursuant to publicly-filed tariffs before the FCC. For MSAs in which a carrier was providing local service in as of June 20, 2001, the FCC benchmark rate from June 20, 2001 through June 19, 2002 is 2.5 cents per minute or the competing incumbent local exchange carrier rate, whichever is higher. For those same MSAs, the FCC benchmark rate from June 20, 2002 through June 19, 2003 is 1.8 cents per minute or the competing incumbent local exchange carrier rate, whichever is higher. For those same MSAs, the FCC benchmark rate from June 20, 2003 through June 19, 2004 is 1.2 cents per minute or the competing incumbent local exchange carrier rate, whichever is higher. Beginning on June 20, 2004, the FCC benchmark rate for those MSAs will be the switched access rate of the competing incumbent local exchange carrier. As of June 20, 2001, Z-Tel was providing local service in most of the MSAs in its current footprint; as a result, the FCC benchmark rates for Z-Tel's interstate switched access charges in those MSAs will, through June 20, 2004, be considerably higher than the FCC benchmark rate for Z-Tel's competitors that begin to provide service in those MSAs after June 20, 2001.

AT&T and Sprint have appealed the FCC's April 2001 CLEC Access Charge Order before the United States Circuit Court for the District of Columbia, arguing that the FCC's benchmark rates are too high and that competitive local exchange carriers like Z-Tel should be required to provide interstate switched

access services at the competing incumbent local exchange carrier rate immediately. Z-Tel has intervened in that court proceeding against those long-distance companies. Two competitive local exchange carriers have also appealed the FCC decision, and several competitive carriers have sought reconsideration or clarification of the FCC's decision. In addition, Z-Tel has sought a waiver of FCC rules requiring it to tariff interstate switched access services at the competing incumbent

local exchange carrier rate for several dozen smaller MSAs that Z-Tel did not have any local subscribers in as of June 20, 2001, arguing to the FCC that the cost to Z-Tel to provide interstate switched access services at two different rate levels in the same state would impose unnecessary costs on Z-Tel that is inconsistent with the public interest. These appeals, reconsiderations, and the waiver request are all pending. The outcome of any of these determinations could have a significant and material impact on Z-Tel's business. In particular, if AT&T and Sprint are successful in requiring Z-Tel and other entrants to charge the competing incumbent local exchange carrier rate for interstate switched access services immediately, it would have a substantial and material adverse effect on Z-Tel's business and competitive advantage.

In 2001, Z-Tel settled pending litigation with AT&T and Sprint over their nonpayment of access charges to Z-Tel. Z-Tel provides interstate and intrastate switched access services to both of those long-distance carriers pursuant to switched access service agreements. Based on history of nonpayment of both of these long-distance carriers to Z-Tel, there is a risk that either or both of these long-distance companies could fail to pay Z-Tel for switched access services. While Z-Tel has in the past and will in the future adamantly litigate and defend its position against these carriers, nonpayment could have a substantial and material adverse impact on our business.

Numbering and Number Portability. In August 1997, the FCC issued rules transferring responsibility for administering and assigning local telephone numbers from the Bell operating companies and other incumbent local exchange carriers to a neutral entity in each geographic region in the United States. In August 1996, the FCC issued new numbering regulations that prohibit states from creating new area codes that could unfairly hinder competitive local exchange carriers by requiring their customers to use 10 digit dialing while existing incumbent local exchange carrier customers use seven digit dialing. In addition, each carrier is required to contribute to the cost of numbering administration through a formula based on net telecommunications revenues. Beginning in March 2000, contributions for this purpose were based on end-user telecommunications revenues and have been submitted in association with FCC Lifeline, Universal Service and the Schools and Libraries Funds.

In July 1996, the FCC released rules requiring all local exchange carriers to have the capability to permit both residential and business consumers to retain their telephone numbers when switching from one local service provider to another, known as "number portability." Number portability has been implemented in most of the areas in which we provide service, but has not been implemented everywhere in the United States. Some carriers have obtained waivers of the requirement to provide number portability, and others have delayed implementation by obtaining extensions of time before compliance is required. Lack of number portability in a given market could adversely affect our ability to attract customers for our competitive local exchange service offerings, particularly business customers, should we seek to provide services to such customers.

In May 1999, the FCC also initiated a proceeding to address the problem of the declining availability of area codes and phone numbers. On December 29, 2000, the FCC issued a Further Notice of Proposed Rulemaking in CC Dockets No. 96-98 and 99-200 that proposed adoption of a "market-based" approach for optimizing number resources. In that Further Notice the FCC seeks input on its tentative conclusion that, through the introduction of charges associated with the allocation of number resources, carriers might be better incentivized to take and retain only as many numbers as they need. If a "market-based" approach to number allocation is introduced, as the FCC has proposed, it could result in added administrative expenses for us and possibly make it more difficult for us to obtain telephone numbers for our customers.

Restrictions on Bundling. On March 30, 2001, in CC Dockets Nos. 96-61 and 98-183, the FCC eliminated a rule that prohibited all carriers from bundling customer premises equipment and telecommunications services. FCC rules also require that nondominant carriers that own common carrier transmission facilities and provide enhanced services may bundle basic telecommunications and enhanced services in packages to customers, but such carriers must make the underlying transmission capacity for the enhanced service available to other enhanced service providers under nondiscriminatory terms and conditions under which they provide such services to their own enhanced service operations.

Slamming. A customer's choice of local or long distance telecommunications company is encoded in a customer record, which is used to route the customer's calls so that the customer is served and billed by the desired company. A user may change service providers at any time, but the FCC and some states regulate this process and require that specific procedures be followed. When these procedures are not followed, particularly if the change is unauthorized or fraudulent, the process is known as "slamming." Slamming is such a significant problem that it has been addressed in detail by Congress in the Telecommunications Act, by some state legislatures, and by the FCC in recent orders. The FCC has levied substantial fines for slamming. The risk of financial damage, in the form of fines, penalties and legal fees and costs, and to business reputation from slamming is significant. Even one slamming complaint could cause extensive litigation expenses for us. The FCC recently decided to apply its slamming rules (which originally

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covered only long distance) to local service as well. Z-Tel is also subject to state rules and regulations regarding slamming, cramming, and other consumer protection regulation.

Network Information. Section 222 of the Communications Act of 1934 and FCC rules protect the privacy of certain information about telecommunications customers that a telecommunications carrier such as us acquires by providing telecommunications services to such customers. Such protected information, known as Customer Proprietary Network Information (CPNI), includes information related to the quantity, technological configuration, type, destination and the amount of use of a telecommunications service. The FCC's original rules prevented a carrier from using CPNI acquired through one of its offerings of a telecommunications service to market certain other services without approval of the affected customer. The United States Court of Appeals for the Tenth Circuit overturned a portion of the FCC's rules established in CC Docket No. 96-115 regarding the use and protection of CPNI.

In response to the Tenth Circuit decision, in October 2001, in CC Docket No. 96-115, the FCC clarified that the Tenth Circuit reversal was limited

and that most of the FCC's CPNI rules remained in effect. The FCC sought further comment on what method of customer consent offered by a carrier (either an "opt-in" or "opt-out" approach) would serve the governmental interest in Section 222 and be consistent with the First Amendment. The final determination of this issue and other FCC rules regarding handling of CPNI could result in significant administrative expense to Z-Tel in modifying internal customer systems to meet these requirements.

Intercarrier Compensation (Interstate Access Charges and Reciprocal Compensation). Because Z-Tel, as a competitive local exchange carrier, passes and receives local and toll calls to and from other local exchange carriers and long-distance companies, the rates for "intercarrier compensation" for these calls has a significant and substantial impact on the profitability of Z-Tel's business. In addition, the rates that Z-Tel's competitors, especially the incumbent local exchange carriers, are permitted to charge end-users, other local exchange carriers, and long-distance companies for originating, transmitting, and terminating telecommunications traffic can have a substantial impact on Z-Tel's ability to offer services in competition with those carriers.

The current regulatory (and intercarrier compensation) status of dial-up calls to Internet service providers is in dispute and litigation. The FCC has determined that both continuous access and dial-up calls from a customer to an Internet service provider are interstate, not local, calls, and, therefore, are subject to the FCC's jurisdiction. The FCC has initiated a proceeding to determine the effect that this regulatory classification will have on the obligation of local exchange carriers to pay reciprocal compensation for dial-up calls to Internet service providers that originate on one local exchange carrier network and terminate on another local exchange carrier network. Moreover, many states have or are considering this issue, and several states have held that local exchange carriers do not need to pay reciprocal compensation for calls terminating at Internet service providers. A majority of state commissions have ruled that reciprocal compensation should be paid on such traffic. On March 24, 2000, the Court of Appeals for the District of Columbia remanded for reconsideration the FCC's determination that calls to Internet service providers are interstate for jurisdictional purposes rather than local. Specifically, the Court indicated that the FCC has not provided a satisfactory explanation why calls to Internet service providers are not local telecommunications traffic and why such traffic is exchange access rather than telephone exchange service. We cannot predict the effect that the FCC's resolution of these issues will have on our business.

Since passage of the Telecommunications Act of 1996, the FCC has fundamentally restructured the "access charges" that incumbent local exchange carriers charge to interexchange carriers and end-user customers to connect to the incumbent local exchange carrier's network. The FCC revised access charges for the largest incumbent local exchange carriers in May 1997, reducing per-minute access charges and increasing flat-rated monthly charges paid by both long-distance carriers and end-users. Further changes in access charges were effected for the largest incumbent local exchange carriers when the FCC adopted the Coalition for Affordable Local and Long-Distance Service (CALLS) proposal in May 2000. CALLS, which reflected a negotiated settlement between AT&T and most of the Bell operating companies, reduced per-minute charges by 60 percent. It further increased flat-rated monthly charges to end-users, in particular, multi-line business users. The CALLS plan also attempted to remove implicit universal service subsidies paid for by long-distance companies in interstate access rates and place those funds into the federal universal service support system, where they would be recovered from all interstate carriers. Most of the reductions in the CALLS plan resulted from shifting access costs away from interexchange carriers onto end-user customers. Last year, the Fifth Circuit reversed and remanded portions of the CALLS plan back to the FCC for further consideration of the issue as to the size of the subsidy for universal service should be removed from the interstate access charges and placed into the federal

interstate universal service support system. The outcome of this litigation could impact the contributions Z-Tel, as an interstate carrier, must pay to support the federal universal service support system.

In addition, as discussed above, the rates that Z-Tel and other competitive local exchange carriers may charge for interstate switched access services are regulated pursuant to the FCC's April 2001 CLEC Access Charge Order.

In April 2001, the FCC released a Notice of Proposed Rulemaking in CC Docket No. 01-92 in which it proposed a "fundamental re-examination of all currently regulated forms of intercarrier compensation." The FCC proposed that carriers transport and terminate local traffic on a bill-and-keep basis, rather than per-minute reciprocal compensation charges. The FCC regards the CALLS Order and the CLEC Access Charge Order as well as its reciprocal compensation rules to be 3-year "transitional intercarrier compensation regimes". After completion of that three-year transition, a new interstate intercarrier compensation regime based upon bill-and-keep or another alternative may be in place. In addition, AT&T and Pulver.com have both filed before the FCC petitions for declaratory rulings that "IP telephony" services offered by them are, in different ways, not subject to the FCC's access charge regime. Because Z-Tel both makes payments to and receives payments from other carriers for exchange of local and long-distance calls, at this time we cannot predict the effect that the FCC's determination in CC Docket No. 01-92 or these IP telephony petitions may have upon our business.

Potential Adverse Federal Legislation. In the past, federal lawmakers have considered bills that would alter the pro-competitive regulatory structure of the 1996 Telecommunications Act and similar state statutes. For example, on February 27, 2002, the U.S. House of Representatives passed H.R. 1542, (the "Tauzin-Dingell" bill). Had that bill been enacted into law, a substantial portion of the Telecommunications Act, including several of the unbundling requirements, would have been overturned. The possibility of similar or other adverse federal legislation being introduced and passed is significant and could have a material, harmful impact on our business. Similar efforts are pending before state legislatures, which are discussed below. Such legislative actions can have a significant and material adverse impact on our business. Other changes to the market-opening and enforcement provisions of the Communications Act could adversely affect our ability to provide competitive services and could harm our business.

Other Issues. There are a number of other issues and proceedings that could have an effect on our business in the future, including the fact that

- The FCC has adopted rules to require telecommunications service providers to make their services accessible to individuals with disabilities, if readily achievable.

- The FCC has also ordered telecommunications service providers to provide law enforcement personnel with a sufficient number of ports and technical assistance in connection with wiretaps. We cannot predict the cost to us of complying with this order.

- The FCC has adopted new rules designed to make it easier for customers to understand the bills of telecommunications carriers. These Truth-in-Billing rules establish certain

requirements regarding the formatting of bills and the information that must be included on bills. These rules have been appealed in Federal court.

- The FTC is considering applying national "do not call" lists to telephone companies that utilize telemarketing. Z-Tel has utilized telemarketing strategies and such regulation could increase the cost and decrease the effectiveness of telemarketing.

- We are subject to annual regulatory fees assessed by the FCC, and must file an annual employment report to comply with the FCC's Equal Employment Opportunity policies.

- The FCC has adopted an order granting limited pricing flexibility to large incumbent local exchange carriers, and is considering granting additional pricing flexibility and price deregulation options. These actions could increase competition for some of our services.

The foregoing is not an exhaustive list of proceedings or issues that could materially affect our business. We cannot predict the outcome of these or any other proceedings before the courts, the FCC, legislative bodies, or state or local governments.

STATE REGULATION

To the extent that we provide telecommunications services that originate and terminate within the same state, we are subject to the jurisdiction of that state's public service commission. As our local service business and product lines expand, we will offer more intrastate services and may become increasingly subject to state regulation. The Telecommunications Act preserves the authority of individual state utility commissions to preside over rate and other proceedings, and to impose their own regulation on local exchange and intrastate interexchange services, so long as such regulation is not inconsistent with the requirements of federal law. For instance,

states may require us to obtain a Certificate of Public Convenience and Necessity before commencing service in the state. We have obtained such authority in all states in which we operate, and, as a prelude to market entry in additional states, we have obtained such authority to provide facilities-based service in forty-nine states. Z-Tel has sought such authority also in Alaska. No assurance can be made that the Alaska state regulatory authority will approve these or additional certification requests in a timely manner. In addition to requiring certification, state regulatory authorities may impose tariff and filing requirements, consumer protection measures, and obligations to contribute to universal service and other funds. State commissions also have jurisdiction to approve negotiated rates, or establish rates through arbitration, for interconnection, including rates for unbundled network elements. Changes in those rates for unbundled network elements could have a substantial and material impact on our business. Our ability to appeal State commission determinations in federal court is subject to considerable legal uncertainty (see "Interconnection Agreements" above).

We are subject to requirements in some states to obtain prior approval for, or notify the state commission of, any transfers of control, sales of

assets, corporate reorganizations, issuance of stock or debt instruments and related transactions. Although we believe such authorizations could be obtained in due course, there can be no assurance that state commissions would grant us authority to complete any of these transactions.

We are also subject to state laws and regulations regarding slamming, cramming, and other consumer protection and disclosure regulations. These rules could substantially increase the cost of doing business in any one particular state. State commissions have issued or proposed several substantial fines against competitive local exchange companies for slamming or cramming. The risk of financial damage, in the form of fines, penalties and legal fees and costs, and to business reputation from slamming is significant. Even one slamming complaint before a state commission could cause extensive litigation expenses for us. In addition, state law enforcement authorities may utilize their powers under state consumer protection laws against us in the event legal requirements in that state are not met. In addition, our wholesale business raises particular risks that could make Z-Tel liable for slamming, cramming or other consumer protection and disclosure violations undertaken by our wholesale customers and sales agents. While we try and ensure that our contracts with our wholesale customers and sales agents provide for indemnification to Z-Tel of such liability, there is substantial risk that Z-Tel may be held liable regardless and that the wholesale customer or agent may not have the financial ability to indemnify Z-Tel fully.

Z-Tel's rates for intrastate switched access services, which Z-Tel provides to long-distance companies to originate and terminate in-state toll calls, are subject to the jurisdiction of the state commissions in which the call originated and terminated. State commissions may, like Texas, directly regulate or prescribe this intrastate switched access rate. Such regulation by other states could materially and adversely affect Z-Tel's revenues and business opportunities within that state.

The Telecommunications Act generally preempts state statutes and regulations that restrict the provision of competitive services. As a result of this preemption, we will be generally free to provide the full range of local, long distance, and data services in any state. While this action greatly increases our potential for growth, it also increases the amount of competition to which we may be subject. States, however, may still restrict Z-Tel's ability to provide competitive services in some rural areas. In addition, the cost of enforcing federal preemption against certain state policies and programs may be large and may cause considerable delay. In particular, we expect to expand our Z-LineHOME service by starting to market this service in several new states during 2003. To effect entry into these markets, we have obtained proper state regulatory certification and entered into interconnection agreements in all states where we operate, except for Michigan and Wisconsin, where we obtain interconnection and access to unbundled network elements through a state tariff. In each jurisdiction where we operate, we anticipate that the incumbent local exchange carrier will provide the unbundled network element platform components in a manner similar to that provided in states where we currently operate. However, pricing and terms and conditions adopted by the incumbent local exchange carrier in each of these states may preclude our ability to offer a competitively viable and profitable product within these and other states on a going-forward basis.

As discussed above, State commissions have an important role to play in implementing the Telecommunications Act, and discussion of particular issues and risks related to that state implementation are contained in the "Federal Regulation" section above. As a result of the FCC's Triennial Review decision, over the next several months, state commissions will likely engage in extensive and detailed review of the availability of unbundled local switching in their states. Limitations or restrictions on the availability of unbundled local switching in any area or to any customer classification could significantly,

materially, and adversely harm our business. In addition, in order to enter new markets, we may be required to negotiate interconnection agreements with incumbent local exchange carriers on an individual state basis. To continue to provide service, we also need to renegotiate interconnection agreements with incumbent local exchange carriers. While current FCC rules and regulations require the incumbent provider to provide the network elements on an individual and combined basis necessary for us to provision end-user services, no assurance can be made that the individual local exchange providers will provide these components in a manner and at a price that will support competitive operations. If the incumbent providers do not readily provide network functionality in the manner required, we have

regulatory and legal alternatives, including arbitration before state public service commissions, to force provision of services in a manner required to support our service offerings. However, if we are forced to litigate in order to obtain the combinations of network elements required to support our service, we are likely to incur significant incremental costs and delays in entering such markets. In addition, as discussed above, there is considerable legal uncertainty as to how interconnection agreements are to be enforced before state commissions and where appeals of state commission interconnection agreement determinations may be heard.

In addition, state lawmakers may consider bills that would alter the pro-competitive regulatory structure of the Telecommunications Act and similar state statutes. Passage of legislation that limits or restricts interconnection or unbundled access to incumbent networks, or that limits the authority or powers of the state regulatory commission, could have a material, harmful impact on our business in those states. For example, SB 1518, pending before the Illinois General Assembly, and SB 377/HB 1658, pending before the Texas legislature, could significantly curtail pro-competitive state initiatives taken in those states by limiting unbundled access and state commission authority. Passage of such adverse legislative actions can have a significant and material adverse impact on our business. Other changes to the market-opening and enforcement provisions of the Communications Act could adversely affect our ability to provide competitive services and could harm our business.

LOCAL GOVERNMENT REGULATION

In some of the areas where we provide service, we may be subject to municipal franchise requirements requiring us to pay license or franchise fees either on a percentage of gross revenue, flat fee or other basis. We may be required to obtain street opening and construction permits from municipal authorities to install our facilities in some cities. The Telecommunications Act prohibits municipalities from discriminating among telecommunications service providers in imposing fees or franchise requirements. In some localities, the FCC has preempted fees and other requirements determined to be discriminatory or to effectively preclude entry by competitors, but such proceedings have been lengthy and the outcome of any request for FCC preemption would be uncertain.

EMPLOYEES

As of March 25, 2003, we had approximately 1,158 employees. None of our employees is covered under collective bargaining agreements.

ACCESS TO INFORMATION

The public may read and copy any materials we file with the Securities and exchange commission at the SEC's Public Reference Room at 450 Fifth Street N.W., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The address of that site is http://www.sec.gov.

Reports we file electronically with the SEC including annual reports on Forms 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those filings are available free of charge soon after each filing at the following Web site: http://www.z-tel.com. Select "Investor Relations" from the drop down menu under "Learn."

ITEM 2. PROPERTIES

We currently lease our principal executive offices in Tampa, Florida and our principal engineering offices in Atlanta, Georgia. Our principal network facilities reside in our Tampa offices. We own our principal consumer services offices in Atmore, Alabama.

ITEM 3. LEGAL PROCEEDINGS

We are a party to various routine administrative proceedings. For more information, please refer to the section entitled "Item 1. Business-Government Regulation."

1. Case No. 01 CV 5074: In re Z-Tel Technologies, Inc. Initial Public Offering Securities Litigation, Master File No. 21 MC 92 (SAS), in the United States District Court for the Southern district of New York (original complaint filed June 7, 2001; Second Corrected Amended Complaint filed July 12, 2002)

During June and July 2001, three separate class action lawsuits were filed against the Company, certain of the Company's current and former directors and officers (the "D&Os") and firms engaged in the underwriting (the "Underwriters") of our initial public offering of stock (the "IPO"). Each of the lawsuits is based on the allegations that the Company's registration statement on Form S-1, filed with the Securities and Exchange Commission ("SEC") in connection with the IPO, contained untrue statements of material fact and omitted to state facts necessary to make the statements made not misleading by failing to disclose that the underwriters had received additional, excessive and undisclosed commissions from, and had entered into unlawful tie-in and other arrangements with, certain customers to whom they allocated shares in the IPO. Plaintiffs have asserted claims against the Company and the D&Os pursuant to Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the SEC thereunder. The plaintiffs seek an undisclosed amount of damages, as well as pre-judgment and post-judgment interest, costs and expenses, including attorneys' fees, experts' fees and other costs and disbursements.

2. Case No. 8:02 CV 1708 T 27 MS The Metropolitan Government of Nashville and Davidson County, Tennessee, suing on behalf of Metropolitan Nashville Employee Benefit Board v Z-Tel Technologies, Inc. in the United States District Court for the Middle District of Florida filed

September 20, 2002.)

Metropolitan Nashville Employee Benefit Board, one of our common shareholders, alleges that we wrongfully and improperly delayed providing them with a stock certificate and that during the time of such delay our stock price plummeted and they were unable to sell or take steps to protect the value of their shares. Metro Nashville seeks compensatory damages in excess of $18 million, plus interest, and punitive damages of $18 million.

3. PUC Docket No. 26417 Before the Public Utility Commission of Texas. Z-Tel Communications, Inc. Complaint for Post-Interconnection Agreement Dispute Resolution, Request for Expedited Ruling, And Request for Interim Ruling Against Southwestern Bell Telephone Company

On August 6, 2002, we filed a complaint against Southwestern Bell Telephone Company ("SWBT") before the Public Utility Commission of Texas (PUCT), requesting that the PUCT enjoin SWBT from disconnecting our access to customers in Texas on the basis of a billing dispute between the parties. The billing dispute centered on whether we owed SWBT certain amounts for collect calls from SWBT retail customers to Z-Tel retail customers. On August 23, 2002, the PUCT issued in part the injunctive relief requested by Z-Tel, making clear that service not be interrupted. Since that injunction, Z-Tel and SWBT have been involved in a dispute resolution process over these and other billing disputes between SWBT and SBC affiliates of SWBT.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITIES HOLDERS

None.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

MARKET INFORMATION

The Company's common shares are traded on the Nasdaq SmallCap Market under the symbol "ZTEL." Our shares were previously traded on the Nasdaq National Market. We downlisted to the SmallCap Market on September 10, 2002.

The following table sets forth, for the periods indicated, the range of high and low closing sale prices for the common shares, as reported on the Nasdaq National Market or the Nasdaq SmallCap Market, as the case may be.

	HIGH	LOW
FISCAL YEAR 2001:		
First Quarter	$6.94	$3.63
Second Quarter	$4.45	$1.40
Third Quarter	$1.65	$0.78
Fourth Quarter	$1.95	$0.80
FISCAL YEAR 2002:		
First Quarter	$2.98	$1.25
Second Quarter	$2.25	$0.35
Third Quarter	$1.55	$0.41

Fourth Quarter	$1.37	$0.70

On March 26, 2003, the last reported sales price of the common stock on the Nasdaq SmallCap Market was $1.36 per share.

HOLDERS

As of March 26, 2003, there were approximately 5,200 shareholders of our common stock.

DIVIDENDS

We have not paid dividends on our common stock since our inception and do not intend to pay any cash dividends for the foreseeable future but instead intend to retain earnings, if any, for the future operation and expansion of our business. Any determination to pay dividends in the future will be at the discretion of our Board of Directors and will be dependent upon our results of operations, our financial condition, restrictions imposed by applicable law and other factors deemed relevant by the Board of Directors. In addition, our ability to pay cash dividends is limited by provisions of our Series D, E, and G Convertible Preferred Stock, which have dividend preferences over our common stock.

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of secur remaining avail for future issu under equit compensation p (excluding secur reflected in co (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	12,493,588	$4.59	2,966,028
Equity compensation plans not approved by security holders			
Total	12,493,588	$4.59	2,966,028

RECENT SALES OF UNREGISTERED SECURITIES

SERIES D CONVERTIBLE PREFERRED STOCK

During July 2000, we sold an aggregate of 4,688,247 shares of $0.01 par value Series D Convertible Preferred Stock (the "Series D Preferred") and warrants (the "Series D Warrants") for the purchase of 2,344,123 shares of our common stock, for aggregate proceeds of approximately $56.3 million. We claim an exemption from registration under Section 4(2) of the Securities Act of 1933 because the transaction was by an issuer and did not involve a public offering.

Each Series D Preferred is convertible into the number of common shares equal to the $12.00 divided by the conversion price, as adjusted. The initial conversion price was $12.00. In addition upon conversion during the first five years, three-fourths of the accrued and unpaid dividends are convertible into common shares at $12.00 per share without adjustment. Each Series D Warrant entitles its holder to purchase one share at an exercise price of $13.80, as adjusted. The conversion price of the Series D Preferred is

subject to adjustment in the case of (i) a dividend or distribution to common shareholders (whether such dividend or distribution is in stock, securities or other property), (ii) a stock split, (iii) a stock combination, (iv) a reclassification of the common stock, (v) the issuance of stock or securities convertible into or exercisable for common stock at a price that is less than the adjusted conversion price and other events that would cause dilution of ownership to the Series D Preferred stock. The Series D Warrants are likewise subject to adjustment upon the occurrence of certain dilutive events.

SERIES E CONVERTIBLE PREFERRED STOCK

During November 2000, we sold an aggregate of 4,166,667 shares of $0.01 par value Series E Convertible Preferred Stock ("Series E Preferred") and a warrant (the "Series E Warrant") for the purchase of 2,083,333 shares of our common stock for aggregate proceeds of approximately $50.0 million. We claim an exemption from registration under Section 4(2) of the Securities Act of 1933 because the transaction was by an issuer and did not involve a public offering.

Each Series E Preferred is convertible into the number of common shares equal to the $12.00, plus accrued and unpaid dividends, divided by the conversion price, as adjusted. The initial conversion price was $12.00. The Series E Warrant entitles its holder to purchase shares at an exercise price of $13.80 per share, as adjusted. The conversion price of the Series D Preferred is subject to adjustment in the case of (i) a dividend or distribution to common shareholders (whether such dividend or distribution is in stock, securities or other property), (ii) a stock split, (iii) a stock combination, (iv) a reclassification of the common stock, (v) the issuance of stock or securities convertible into or exercisable for common stock at a price that is less than the adjusted conversion price and other events that would cause dilution of ownership to the Series E Preferred stock. The Series E Warrant is likewise subject to adjustment upon the occurrence of certain dilutive events.

SERIES G JUNIOR CONVERTIBLE PREFERRED STOCK

On July 5 and August 3, 2001, we sold an aggregate of 175 shares of $0.01 par value Series G Junior Convertible Preferred Stock (the "Series G Preferred") and warrants (the "Series G Warrants") for the purchase of 3,000,000 shares of our common stock for aggregate proceeds of $17.5 million. We claim an exemption from registration under Section 4(2) of the Securities Act of 1933 because the transaction was by an issuer and did not involve a public offering.

Each Series G Preferred is convertible into the number of common shares equal to the $100,000.00, plus accrued and unpaid dividends, divided by conversion price, as adjusted. The initial conversion price was $1.49. Each Series G Warrant entitles its holder to purchase one share at an exercise price of $0.01 per share, as adjusted. The conversion price of the Series G Preferred is subject to adjustment in the case of (i) a dividend or distribution to common

shareholders (whether such dividend or distribution is in stock, securities or other property), (ii) a stock split, (iii) a stock combination, (iv) a reclassification of the common stock, (v) the issuance of stock or securities convertible into or exercisable for common stock at a price that is less than the adjusted conversion price and other events that would cause dilution of ownership to the Series G Preferred stock. The Series G Warrants are likewise subject to adjustment upon the occurrence of certain dilutive events.

COMMON SHARES

On March 20, 2002, we issued 1,000,000 shares of our common stock to MCI WORLDCOM Communications, Inc. ("MCI") in connection with a certain Agreement for Wholesale Telephone Exchange Services, Z-Node Services, Ancillary Services and Technology License between Z-Tel Communications, Inc., our wholly-owned subsidiary, and MCI. The shares were sold for