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

Telephone and Data Systems, Inc. ("TDS") is a diversified telecommunications company providing high-quality telecommunications services to approximately 6.1 million wireless telephone customers and wireline telephone equivalent access lines in 36 states at December 31, 2004. TDS conducts substantially all of its wireless telephone operations through its 82.0%-owned subsidiary, United States Cellular Corporation ("U.S. Cellular"), and its incumbent local exchange carrier and competitive local exchange carrier wireline telephone operations through its wholly owned subsidiary, TDS Telecommunications Corporation ("TDS Telecom").

The following discussion and analysis should be read in conjunction with TDS's audited consolidated financial statements and footnotes included herein and the description of TDS's business included in Item 1 of the TDS Annual Report on Form 10-K for the year ended December 31, 2004.

OVERVIEW

The following is a summary of certain selected information from the complete management discussion that follows the overview and does not contain all of the information that may be important. You should carefully read this entire Management's Discussion and Analysis of Financial Condition and Results of Operations and not rely solely on the overview.

U.S. Cellular – U.S. Cellular positions itself as a regional operator, focusing its efforts on providing wireless service to customers in the geographic areas where it has licenses to provide such service. U.S. Cellular differentiates itself from its competitors through a customer satisfaction strategy, reflecting a customer service focus and a high-quality wireless network.

U.S. Cellular's business development strategy is to purchase controlling interests in wireless licenses in areas adjacent to or in proximity to its other wireless licenses, thereby building contiguous operating market areas. Its largest contiguous service area is in the Midwest/Southwest, where it serves 3.0 million customers and has licenses covering a total population of more than 31 million. U.S. Cellular's operating strategy is to strengthen the geographic areas where it can continue to build long-term operating synergies and to exit those areas where it does not have opportunities to build such synergies. U.S. Cellular's most recently completed transactions are summarized below.

- Carroll Wireless, L.P. ("Carroll Wireless"), an entity in which U.S. Cellular is a limited partner, was a successful bidder for 17 licensed areas in the auction of wireless spectrum designated by the FCC as Auction 58, which ended on February 15, 2005. These 17 licensed areas cover portions of 11 states and are in markets which are either adjacent to or overlap current U.S. Cellular licensed areas.
- On December 20, 2004, U.S. Cellular completed the sale of the Daytona Beach, Florida 20 megahertz C block personal communication service license to MetroPCS California/Florida, Inc. ("MetroPCS") for $8.5 million.
- On November 30, 2004, U.S. Cellular completed the sale of certain wireless properties to ALLTEL Communications, Inc. ("ALLTEL") for $80.2 million in cash, subject to a working capital adjustment. The properties sold included two consolidated operating markets and five minority interests.
- On February 18, 2004, U.S. Cellular completed the sale of certain wireless properties in southern Texas to AT&T Wireless Services, Inc. ("AT&T Wireless"), now a subsidiary of Cingular Wireless LLC ("Cingular"), for $96.5 million in cash.
- On August 1, 2003, U.S. Cellular completed the transfer of properties to AT&T Wireless and the assignments to it by AT&T Wireless of a portion of the wireless licenses covered by the agreement with AT&T Wireless. On the initial closing date, U.S. Cellular transferred wireless assets and customers in 10 markets in Florida and Georgia to AT&T Wireless. In return, U.S. Cellular received approximately $34 million in cash and minority interests in six wireless markets in which it owns a controlling interest.

  In addition to the cash and minority interests, U.S. Cellular will have received a total of 36 wireless licenses in 13 states when the transaction is fully consummated. U.S. Cellular has deferred the assignment and development of 21 of these licenses it has the right to acquire from AT&T Wireless for up to five years from August 1, 2003.

  U.S. Cellular launched service in Lincoln, Nebraska; Oklahoma City, Oklahoma; and Portland, Maine in 2004. Licenses for these markets were acquired as part of the 2003 transaction with AT&T Wireless.
- On August 7, 2002, U.S. Cellular completed the acquisition of the "Chicago market," a 20 megahertz license in the Chicago major trading area (excluding Kenosha County, Wisconsin) for $617.8 million.

U.S. Cellular operating income increased 49% in 2004 and decreased 58% in 2003. The increase in 2004 primarily reflected increased revenues and gains on assets held for sale and the absence of losses on impairments and assets held for sale compared to 2003. The increase in 2004 was offset by increased expenses related to the launch of new markets, decreased operating income due to divestitures of markets, increased equipment subsidies and increased depreciation expense. The decrease in 2003 was primarily due to expenses related to increased customer usage along with development of new markets. U.S. Cellular's operating income was significantly affected by the loss on assets held for sale and loss on impairment of intangible assets in 2003. The operating income margins (as a percent of service revenues) were 6.7% in 2004, 4.9% in 2003 and 13.4% in 2002.

Although operating margins improved in 2004, TDS anticipates that there will be continued pressure on U.S. Cellular operating income and margins in the next few years related to the following factors:

- costs of customer acquisition and retention;
- competition;
- increased customer use of U.S. Cellular's services;
- launching service in new areas;
- reduced inbound roaming revenues; and
- continued enhancements to U.S. Cellular's wireless network.

The effects of these factors are expected to be mitigated to some extent by the following factors:

- reduced customer usage costs per minute and outbound roaming costs per minute; and
- expansion of revenues from data-related services and newly launched markets.

In the exchange and divestiture transactions listed above, U.S. Cellular has divested operations that were generating revenues, cash flows from operations and operating income. However, a significant portion of such revenues, cash flows from operations and operating income was attributable to inbound roaming traffic and was not primarily generated by U.S. Cellular's customers in those markets. In exchange, U.S. Cellular received cash and received or will receive licenses that will be in a development phase for several years. U.S. Cellular uses cash proceeds from these transactions to help defray costs related to building out new markets. U.S. Cellular anticipates that it may require debt or equity financing over the next few years for capital expenditures, for the development of these new markets and to further its growth in recently launched markets.

See "Results of Operations – Wireless Telephone Operations."

TDS Telecom – TDS Telecom provides high-quality telecommunication services, including full-service local exchange service, long distance telephone service, and Internet access, to rural and suburban communities. TDS Telecom's business plan is designed for a full-service telecommunications company, including competitive local exchange carrier operations, by leveraging TDS Telecom's strength as an incumbent local exchange carrier. TDS Telecom is focused on achieving three central strategic objectives: growth, market leadership, and profitability. TDS Telecom's strategy includes gaining additional market share and deepening penetration of vertical services within established markets. The strategy places primary emphasis on small- and medium-sized commercial customers and residential customers.

Both incumbent local exchange carriers and competitive local exchange carriers are faced with significant challenges, including the industry decline in use of second lines by customers, growing competition from wireless and other wireline providers, changes in regulation, new technologies such as Voice over Internet Protocol, and the uncertainty in the economy. These challenges could have a material adverse effect on the financial condition, results of operations and cash flows of TDS Telecom.

TDS Telecom was able to increase customers and revenues in 2004 and 2003. By penetrating into existing markets, TDS Telecom's competitive local exchange carrier equivalent access lines increased 17% and 25% in 2004 and 2003, respectively, which led to 7% and 21% increases in revenues. TDS Telecom's incumbent local exchange carrier increased revenues slightly in both years through sales of vertical services such as long distance and DSL services to existing customers. TDS Telecom has also managed to remain profitable by continually seeking ways to control costs. Operating margins were 5% and 17% in 2004 and 2003, respectively. The significant decline in operating margin was a result of losses on impairment of long-lived assets and intangible assets of the competitive local exchange carrier operations. In 2004, TDS Telecom recorded a loss on impairment of long-lived assets of $87.9 million and a loss on impairment of intangible assets of $29.4 million in the Statement of Operations associated with the competitive local exchange carrier operations.

On November 30, 2004, TDS Telecom completed the sale of certain wireless properties to ALLTEL for $62.7 million in cash, subject to a working capital adjustment. The properties sold included a majority interest in one market and an investment interest in one market.

See "Results of Operations – Wireline Telephone Operations."

Financing Initiatives – TDS and its subsidiaries had cash and cash equivalents totaling $1,168.6 million, $1,266.4 million of revolving credit facilities and an additional $75.0 million of bank lines of credit as of December 31, 2004. TDS and its subsidiaries are also generating substantial internal funds from operations. Cash flow from continuing operating activities totaled $747.4 million in 2004, $920.4 million in 2003 and $793.6 million in 2002. In addition, TDS currently has access to public and private capital markets to help meet its long-term financing needs. TDS anticipates that it may require funding over the next few years for capital expenditures and for the development of new wireless markets at U.S. Cellular. Management believes that cash on hand, expected future cash flows from operations and existing sources of external financing provide substantial financial flexibility and are sufficient to permit TDS and its subsidiaries to finance its contractual obligations and anticipated capital expenditures.

TDS is committed to maintaining a strong Balance Sheet and its investment grade rating. During 2004, 2003 and 2002, TDS entered into several financing transactions that have provided financial flexibility as it continues to grow its wireless and wireline businesses:

2004

- U.S. Cellular sold $330 million of 30-year, 7.5% senior notes and $100 million of 30-year, 6.7% senior notes, the proceeds of which were used to redeem $250 million of 7.25% senior notes and $163.3 million of 6% zero coupon convertible redeemable debentures (also known as Liquid Yield Option Notes).
- TDS and U.S. Cellular extended the maturity date of their respective revolving credit facilities to December 2009.
- TDS repurchased 214,800 of its Common Shares and U.S. Cellular repurchased 91,700 of its Common Shares.

2003

- TDS redeemed $300 million of its Trust Originated Preferred Securities.
- U.S. Cellular sold $444 million of 30-year, 6.7% senior notes.

- U.S. Cellular increased the capacity of its revolving credit facility entered into in 2002 from $325 million to $700 million, and canceled its $500 million revolving credit facility.
- TDS redeemed medium-term notes of $70.5 million.
- TDS repurchased 1,961,000 of its Common Shares.

2002

- TDS and U.S. Cellular monetized their investments in marketable equity securities through variable prepaid forward contracts ("forward contracts") which mature in 2007 and 2008, receiving $1.6 billion of cash.
- U.S. Cellular sold $130 million of 30-year, 8.75% senior notes.
- U.S. Cellular established a five-year, $325 million revolving credit facility with a series of banks.
- TDS redeemed medium-term notes of $51.0 million.

See "Financial Resources" and "Liquidity and Capital Resources."

RESULTS OF OPERATIONS

Operating Revenues increased $275.2 million, or 8%, to $3,720.4 million in 2004 from $3,445.2 million in 2003, and increased $446.7 million, or 15%, in 2003 from $2,998.5 million in 2002 reflecting growth in wireless customers. U.S. Cellular operating revenues increased $254.8 million, or 10%, to $2,837.6 million in 2004 from $2,582.8 million in 2003, and increased $385.2 million, or 18%, in 2003 from $2,197.6 million in 2002. Revenue growth primarily reflects wireless customer growth of 12% in 2004 and 7% in 2003 including the divestitures of 91,000 and 141,000 customers in 2004 and 2003, respectively. TDS Telecom operating revenues increased $20.4 million, or 2%, to $882.8 million in 2004 from $862.4 million in 2003, and increased $61.5 million, or 8%, in 2003 from $800.9 million in 2002. Wireline equivalent access lines increased by 6% in 2004 and 8% in 2003. The majority of growth in equivalent access lines in both years occurred at TDS Telecom's competitive local exchange operations.

Operating Expenses increased $322.3 million, or 10%, to $3,499.6 million in 2004 from $3,177.3 million in 2003, and increased $565.2 million, or 22%, in 2003 from $2,612.1 million in 2002. U.S. Cellular operating expenses increased $196.1 million, or 8%, to $2,659.9 million in 2004 from $2,463.8 million in 2003, and increased $547.4 million, or 29%, in 2003 from $1,916.4 million in 2002 due primarily to the costs associated with providing service to an expanding customer base, additional depreciation expense and launching new markets and acquisitions. Also included in U.S. Cellular's operating expenses in 2003 is $45.9 million of losses on assets of operations held for sale and $49.6 million of losses on impairment of intangible assets.

TDS Telecom operating expenses increased $126.3 million, or 18%, to $839.8 million in 2004 from $713.5 million in 2003, and increased $17.8 million, or 3%, in 2003 from $695.7 million in 2002. The increase in 2004 was primarily caused by an $87.9 million loss on the impairment of long-lived assets and a $29.4 million loss on the impairment of intangible assets. These impairments resulted from the write-off of property, plant and equipment, and goodwill at the competitive local exchange carrier business. The increase in 2003 was primarily caused by increased cost of services and products at the incumbent local exchange carrier, offset somewhat by a decline in competitive local exchange carrier costs. Also included in TDS Telecom's operating expenses in 2003 was $5.0 million of losses on impairment of long-lived assets. Of this amount, $4.6 million was at the competitive local exchange carriers and $0.4 million was at the incumbent local exchange carriers.

During 2004, TDS revised its accounting for certain operating leases that contain fixed rental increases to recognize lease revenue and expense on a straight-line basis over the lease term in accordance with Statement of Financial Accounting Standards ("SFAS") No. 13, "Accounting for Leases," as amended, and related pronouncements. Pursuant to its revised accounting for such leases, TDS recorded out-of-period adjustments to operating revenues and operating expenses during 2004. The adjustments were not considered material to the current year or to any prior years' earnings, earnings trends or individual financial statement line items. The adjustments were recorded in 2004, and no prior periods were adjusted. The impact of the out-of-period adjustments reduced operating income by $3.8 million ($3.1 million at U.S. Cellular, $0.7 million at TDS Telecom), investment and other income (expense) by $1.6 million, and net income by $2.9 million, or $0.05 per diluted share.

Operating Income decreased $47.1 million, or 18%, to $220.8 million in 2004 from $267.9 million in 2003, and decreased $118.5 million, or 31%, in 2003 from $386.4 million in 2002. U.S. Cellular's operating income increased $58.8 million, or 49%, to $177.8 million in 2004 from $119.0 million in 2003, and decreased $162.2 million, or 58%, in 2003 from $281.2 million in 2002. The increase in 2004 primarily reflected increased revenues and gains on assets held for sale and the absence of losses on impairments and assets held for sale compared to 2003. The increase in 2004 was offset by increased expenses related to the launch of new markets, decreased operating income due to divestitures of markets, increased equipment subsidies and increased depreciation expense. The decline in 2003 reflects the costs associated with the acquisition of the Chicago market and increased marketing and depreciation expenses. U.S. Cellular's 2003 operating income was significantly affected by the $45.9 million loss on assets held for sale and the $49.6 million loss on impairment of intangible assets. TDS Telecom's operating income decreased $105.9 million, or 71%, to $43.0 million in 2004 from $148.9 million in 2003, and increased $43.7 million, or 42%, in 2003 from $105.2 million in 2002. The decrease in 2004 primarily reflects the competitive local exchange carrier losses on the impairment of long-lived assets of $87.9 million and goodwill of $29.4 million. The increase in 2003 reflects improved operating results from the competitive local exchange carrier business.

Investment and other income (expense) primarily includes interest and dividend income, investment income, gain (loss) on investments and interest expense.