AT&T CORP
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Subject Company: AT&T Corp.

Commission File No.: 1-01105

BEFORE

THE PUBLIC UTILITIES COMMISSION OF OHIO

Joint Application of	)	
	)	
SBC COMMUNICATIONS INC. and	)	
AT&T CORP.	)	
	)	Case No. 05-0269-TP-ACO
	)	
for Consent and Approval of a	)	
Change of Control	)	
	)	

JOINT APPLICATION OF SBC COMMUNICATIONS INC. AND

AT&T CORP. FOR CONSENT AND APPROVAL OF A CHANGE OF CONTROL

DISCLOSURE STATEMENT

In connection with the proposed transaction, SBC intends to file a registration statement, including a proxy statement of AT&T Corp., and other materials with the Securities and Exchange Commission (the SEC). Investors are urged to read the registration statement and other materials when they are available because they contain important information. Investors will be able to obtain free copies of the registration statement and proxy statement, when they become available, as well as other filings containing information about SBC and AT&T Corp., without charge, at the SEC s Internet site (www.sec.gov). These documents may also be obtained for free from SBC s Investor Relations web site (www.sbc.com/investor_relations) or by directing a request to SBC Communications Inc., Stockholder Services, 175 E. Houston, San Antonio, Texas 78205. Free copies of AT&T Corp. s filings may be accessed and downloaded for free at the AT&T Investor Relations Web Site (www.att.com/ir/sec) or by directing a request to AT&T Corp., Investor Relations, One AT&T Way, Bedminster, New Jersey 07921.

SBC, AT&T Corp. and their respective directors and executive officers and other members of management and employees may be deemed to be participants in the solicitation of proxies from AT&T shareholders in respect of the proposed transaction. Information regarding SBC s directors and executive officers is available in SBC s proxy statement for its 2004 annual meeting of stockholders, dated March 11, 2004, and information regarding AT&T Corp. s directors and executive officers is available in AT&T Corp. s proxy statement for its 2004 annual meeting of shareholders, dated March 25, 2004. Additional information regarding the interests of such potential participants will be included in the registration and proxy statement and the other relevant documents filed with the SEC when they become available.

Cautionary Language Concerning Forward-Looking Statements

Certain matters discussed in this statement, including the appendices attached, are forward-looking statements that involve risks and uncertainties. Forward-looking statements include, without limitation, the information concerning possible or assumed future revenues and results of operations of SBC and AT&T, projected benefits of the proposed SBC/AT&T merger and possible or assumed developments in the telecommunications industry. Readers are cautioned that the following important factors, in addition to those discussed in this statement and elsewhere in the proxy statement/prospectus to be filed by SBC with the Securities and Exchange Commission, and in the documents incorporated by reference in such proxy statement/prospectus, could affect the future results of SBC and AT&T or the prospects for the merger: (1) the ability to obtain governmental approvals of the merger on the proposed terms and schedule; (2) the failure of AT&T shareholders to approve the merger; (3) the risks that the businesses of SBC and AT&T will not be integrated successfully; (4) the risks that the cost savings and any other synergies from the merger may not be fully realized or may take longer to realize than expected; (5) disruption from the merger making it more difficult to maintain relationships with customers, employees or suppliers; (6) competition and its effect on pricing, costs, spending, third-party relationships and revenues; (7) the risk that Cingular LLC could fail to achieve, in the amount and within the timeframe expected, the synergies and other benefits expected from its acquisition of AT&T Wireless; (8) final outcomes of various state and federal regulatory proceedings and changes in existing state, federal or foreign laws and regulations and/or enactment of additional regulatory laws and regulations; (9) risks inherent in international operations, including exposure to fluctuations in foreign currency exchange rates and political risk; (10) the impact of new technologies; (11) changes in general economic and market conditions; and (12) changes in the regulatory environment in which SBC and AT&T operate.

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JOINT APPLICATION OF SBC COMMUNICATIONS INC. AND

AT&T CORP. FOR CONSENT AND APPROVAL OF A CHANGE OF CONTROL

I. INTRODUCTION

1. SBC Communications Inc. (SBC) and AT&T Corp. (AT&T) (collectively, the Applicants), pursuant to Section 4905.402 of the Ohio Revised Code (ORC), request that the Public Utilities Commission of Ohio (the Commission) approve a change in the ownership of AT&T, the parent holding company of AT&T Communications of Ohio, Inc. (AT&T Ohio) and TCG Ohio.(1) The merger will make AT&T a wholly owned first-tier subsidiary of SBC. In accordance with the Agreement and Plan of Merger jointly entered into by SBC and AT&T on January 30, 2005 (Exhibit A hereto), the combined organization will be owned approximately 84% by SBC s current shareholders and 16% by AT&T s current shareholders. As described in more detail below, the merger will be accomplished through an exchange of stock of the two companies. AT&T Ohio and TCG Ohio will continue to exist in their present form. The Joint Applicants also seek a one-year waiver of Rule 4901:1-6-08(A).

2. The combination of the national and international operations of SBC and AT&T responds to profound technological and marketplace changes by bringing together two U.S. companies with complementary strengths so that they may serve their customers better.

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(1) The Ohio Bell Telephone Company, which uses the registered trade name SBC Ohio (SBC Ohio), 45 Erieview Plaza, Room 1600, Cleveland, Ohio 44114, is SBC s ILEC operating subsidiary in the State of Ohio, and is authorized to provide telecommunications services pursuant to Certificate Number 90-5032. SBC s certificated subsidiaries in Ohio and affiliates also include SBC Telecom, Inc., Certificate Number 90-9146 (Case No. 00-771-TP-ACE), which is authorized to provide competitive local exchange services in the Cincinnati, Lebanon/Mason, Hudson/Twinsburg, and Delaware market areas; SBC Long Distance, Inc., Certificate Number 90-6150, which received a statewide certificate to provide interexchange services in Case No. 02-3076-CT-ACE; Ameritech Advanced Data Services of Ohio, Inc. d/b/a SBC Advance Solutions, Inc., Certificate Number 90-5181; Cincinnati SMSA Limited Partnership d/b/a Cingular, Certificate Number 90-5304; Ameritech Wireless Communications, Inc. d/b/a Cingular, Certificate Number 90-5354; and Ameritech Mobile Communications, Inc. d/b/a SBC Paging, Certificate Number 90-5541. This Commission has pending before it a joint application of SBC Telecom, Inc. and SBC Long Distance for the consolidation of the Ohio operating authority of both entities into SBC Long Distance, LLC. Case No. 04-1883-TP-UNC. The merger of SBC and AT&T will not affect the proposed consolidation in any fashion. The SBC subsidiaries are not being transferred or undergoing a change in control as a result of this merger.

Together, and more so than either company acting alone, SBC and AT&T will be poised to deliver better, more innovative products and services to consumers and business customers, and to accelerate the deployment of advanced, next-generation Internet Protocol (IP) networks and services. The combined organization will be more highly innovative and financially stronger, and thus better able to meet the needs of all its customers.

Significant Public Interest Benefits Will Flow From the Merger

3. Significant public interest benefits will flow to both residential and business customers by combining two companies with complementary strengths. SBC brings to the merger its financial strength and a range of voice, data, broadband, and related services that it provides to residential, business, and wholesale customers, primarily on a local and regional basis. AT&T brings a global presence in 50 countries, national and global IP-based networks, a portfolio of data and IP services, hosting, security and professional services, technology leadership through AT&T Labs, skilled networking capabilities, and a base of government and large business customers.

4. The merger will result in increased innovation, lead to the more rapid introduction of new services, and prompt the development of services that otherwise would not exist. The merger will increase incentives for investment in innovation and facilitate a wider and swifter diffusion of the innovation that emerges from AT&T Labs, which is one of the world s leading corporate research and development organizations. As a result, residential and small business customers should ultimately enjoy capabilities that once were available only to the largest business and government customers.

5. The merged company will seek to offer a broader array of services to a broader spectrum of customers than either company could on its own. As a result of the combination of

the two companies networks, transport will be more efficient, reliability will increase, and the quality of service will be higher on the combined organization s network.

6. This transaction will benefit customers throughout the country and internationally. The merger will create a vigorous U.S.-based carrier with global reach by combining AT&T s network that spans 50 countries and AT&T Labs technological innovation with SBC s financial strength and local exchange, broadband, and wireless solutions.

Response to Technological and Marketplace Changes

7. The Telecommunications Act of 1996 (the 1996 Act) removed barriers to competitive entry in local exchange and long distance services. No longer are providers restricted to specific lines of business or geographic territories, and the result has been lower prices, expanded output, and a wide diversity of suppliers of a multitude of products and services.

8. At the same time, the industry has experienced unprecedented innovation. New technologies have advanced at a rapid rate to challenge and displace traditional communications services. Wireline and wireless networks are far more robust, faster, and with greater bandwidth at all levels than they were just a few years ago. The growth of national wireless networks and the development of new wireless technologies have provided alternatives for consumers of voice and data services. The shift from dial-up to broadband Internet access first via cable modems, then through massive investment in DSL has unleashed a dramatic expansion of the content and service available to tens of millions of Americans. The widespread adoption of broadband connections to the Internet has fueled the spread of voice over Internet Protocol (VoIP). Cable operators and others are rapidly exploiting this technology to compete more aggressively for voice services, including in packages with video and high-speed Internet access. Comcast, for

example, has committed to make VoIP available to more than 21 million customers by 2006. Press Release, Comcast Investor Relations (Jan. 10, 2005), *available at* http://www.cmcsk.com/phoenix.zhtml?c=118591&p=irol-newsArticle&ID=660894&highlight=.

9. These developments underscore why the merger of SBC and AT&T provides such an ideal opportunity at this juncture, when intermodal competitors (wireless and cable in particular) are challenging the traditional networks. The existence of separate local and long distance companies is no longer viable and certainly does not benefit consumers. Neither SBC nor AT&T standing alone has the assets and expertise necessary to assemble a true nationwide end-to-end broadband network.

10. Indeed, the continuing entry of new competitors and the introduction of new technologies have pushed carriers to accelerate investment in their networks, not only to support the voice and data services of the 1990s, but also to introduce and deploy widely the full suite of IP-platform voice, data, and video services of the packetized age.

11. A decade of technological changes also has led to financial reverses and a shakeout in the industry. Business failures, retrenchments, and product shifts have led to the elimination of hundreds of thousands of jobs, and the loss of more than $2 trillion in market value. And since the dot-com and tech meltdowns, the capital markets have recognized the increased business risks inherent in the communications industry, which has constrained access to capital while increasing its costs.

12. This transaction responds to these developments by bringing together SBC and AT&T to create a more competitive and more enduring global competitor than either company would be alone. The combined organization will be capable of delivering the advanced network

technologies necessary to offer integrated, innovative, high-quality and competitively priced communications and information services to meet the evolving needs of customers worldwide.

Competition Will Not Be Impaired

13. The merger will not reduce competition. In the current IP world, voice and data services are both merely the transmission of bits over the same network. These IP-based services are rapidly becoming available to residential and business customers. Likewise, with wireless communications becoming increasingly widespread, assessment of the effect of the merger on competition cannot ignore the very substantial and growing substitution of wireless for wireline service by both consumers and businesses. Indeed, in 2005, for the first time, there will be more wireless than wireline connections in the United States. Frost & Sullivan, U.S. Communication Services Market Overview and Future Outlook, at 89 (2004). Substitution of wireless minutes for wireline usage has been growing at a rapid pace, and an increasing number of consumers are pulling their second lines or even completely cutting the cord. The introduction of 3G wireless services will intensify this trend. In an environment where wireline carriers compete with cable operators, other VoIP providers, wireless carriers and others, this transaction will not reduce competition. Rather, pairing the complementary strengths of the two companies will enhance competition and benefit all types of customers.

14. That same conclusion follows when focusing on the wireline segment of the market. The operations of the two companies are largely complementary AT&T is focused on national and global enterprise customers with sophisticated needs, while SBC focuses on residential consumers and smaller and regional businesses whose operations are primarily inside SBC s 13-state region. Moreover, in each segment in which the companies compete, there are numerous other competitors and no likelihood of anti-competitive effects.

15. The merger will not diminish competition for mass market customers. Well before the Merger Agreement, AT&T made a unilateral decision to discontinue actively marketing local and long distance service to residential and small business customers. As evidenced by AT&T s pre-merger activities, it is clear that AT&T s decision is irreversible. AT&T has already dismantled infrastructure required to recruit new mass market customers by shutting call centers, cutting its marketing force, and terminating vendor contracts.

16. Not only is AT&T no longer an active competitor for mass market customers, but increasingly the competition for such customers is coming from cable operators offering VoIP and other IP-based services, other VoIP providers, and wireless carriers, in addition to traditional competitors such as ILECs and CLECs. For all these reasons, the merger will have no adverse effect on mass market competition.

17. Nor will the merger have an adverse effect on the highly competitive business segments of the market. These segments of the communications industry have long been vigorously competitive, with numerous competitors and sophisticated customers. *In re Motion of AT&T Corp. To Be Reclassified as a Non-Dominant Carrier*, Order, 11 FCC Rcd. 3271, 3306, ¶ 65, 3308 ¶ 71 (1995) (*AT&T Non-Dominance Order*). The services provided are often differentiated from one customer to the next; and many competitors with different strategies and competitive strengths are competing for these customers.

18. As discussed above, SBC s services and those offered by AT&T are largely complementary. SBC and AT&T typically focus on different sets of enterprise business opportunities. SBC s strength is in the sale of services to small and medium-sized businesses with a high percentage of their facilities in SBC s 13 in-region states. AT&T s strength is in the sale of services nationwide and globally to large multi-location businesses. As a combined

organization, they will be able to offer a portfolio of services suitable for any customer. The merger will allow the combined organization to increase and accelerate investment in its network and to make new innovative services available to mid-sized and smaller businesses.

No Effect on Commission Jurisdiction

19. Following the merger, described in detail below, AT&T will become a wholly owned first-tier subsidiary of SBC. The merger will be transparent and seamless for the customers of the operating subsidiaries of AT&T in Ohio. The Commission will retain the same regulatory authority that it possesses today over the AT&T subsidiaries that are certificated by this Commission and subject to its regulatory authority. SBC Ohio, AT&T Ohio, and TCG Ohio will continue to hold the same state certificates that they currently hold and will not transfer any assets or certificates in connection with the merger.

20. AT&T currently directly or indirectly owns and controls AT&T Ohio and TCG Ohio, which are authorized to provide local exchange telecommunications services (among other services, as set forth more fully below) within Ohio. Upon completion of the merger, the AT&T subsidiaries certificated and operating in Ohio will be owned by the same entities that own them today.

21. In sum, the merger of SBC and AT&T is in the public interest. The merger will permit the Applicants to continue providing existing services at just and reasonable rates, will augment the competitive markets in Ohio and nationwide, and will not adversely affect this Commission s authority to regulate the AT&T (and SBC) operating subsidiaries subject to the Commission s jurisdiction. Indeed, the merger will enhance the abilities of those operating subsidiaries to offer a broad array of existing and emerging telecommunications and information services by bringing together two industry leaders with complementary strengths and by

capitalizing on the synergies related to the companies shared values of customer service, innovation, and reliability.

22. Accordingly, the Joint Applicants respectfully request the Commission s prompt approval of the change in ownership and a prompt grant of its waiver request. The Joint Applicants offer the following additional information in support of this Application:

Description of Joint Applicants

23. The legal name and principal place of business of SBC, a Delaware corporation, is

SBC Communications Inc.

175 East Houston Street

San Antonio, Texas 78205

SBC is a holding company and does not directly provide any services in Ohio or elsewhere. SBC s various subsidiaries provide voice, data, and Internet services to residential, business, and government customers, mostly in a 13-state region. SBC s subsidiaries serve 52.4 million access lines and have 5.1 million DSL lines in service. SBC holds a 60 percent economic and 50 percent voting interest in Cingular Wireless, which serves 49.1 million wireless customers. Through alliances with GSM-based providers, Cingular offers coverage in 170 countries worldwide. SBC is also making a $4 billion investment to bring next-generation Internet Protocol-based (IP-based) services to 18 million households within 3 years. A more detailed description of SBC s business is provided in Exhibit H hereto, SBC s most recent annual report.

24. The legal name and principal place of business of AT&T, a New York corporation, is

AT&T Corp.

One AT&T Way

Bedminster, New Jersey 07921

AT&T provides domestic and international voice and data communications services to residential, business, and government customers in the United States and around the world. AT&T operates sophisticated global communications networks that support IP traffic as well as other data and voice traffic. AT&T s network operations are supported by AT&T Laboratories, a world-leading source of research and development. A more detailed description of AT&T s business is provided in Exhibit I hereto, AT&T s most recent annual report.

25. The legal name and principal place of business of AT&T Ohio is

AT&T Communications of Ohio, Inc.

One AT&T Way

Bedminster, New Jersey 07921

AT&T Ohio is an operating subsidiary of AT&T Corp. AT&T Ohio is authorized to provide local exchange services in 84 counties in the State of Ohio pursuant to Certificate Number 90-9000. AT&T Ohio is also certified to provide long distance service in Ohio.

26. The duly authorized fictitious name and principal place of business of TCG Ohio is

TCG Ohio

One AT&T Way

Bedminster, New Jersey 07921

TCG Ohio is a New York general partnership with two partners, TCG Holdings Joint Venture Holdings, Inc. and TCG Partners, which in turn are wholly owned indirect subsidiaries of AT&T Corp. TCG Ohio is authorized to provide local exchange services in 84 counties in the State of Ohio pursuant to Certificate Number 90-9010. TCG Ohio is also certified to provide long distance service in Ohio.

Designated Contacts and Service Addresses

27. Notices and other pleadings in connection with this Joint Application should be served on SBC and AT&T as follows:

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Description of the Merger

28. On January 30, 2005, SBC and AT&T entered into an Agreement and Plan of Merger (Merger Agreement). A copy of the Merger Agreement is attached hereto as Exhibit J.

29. The Merger Agreement provides for a business combination (merger) of SBC and AT&T pursuant to which AT&T will be merged into a wholly owned first-tier subsidiary of SBC. The SBC subsidiary is a newly formed entity, created for the specific purpose of this transaction, named Tau Merger Sub Corporation (Tau). Tau will merge with and into AT&T Corp., and AT&T will be the surviving entity of the merger with Tau for all legal purposes. The combined entity will retain the name AT&T Corp.

30. At the time of the SBC/AT&T merger, shareholders of AT&T will exchange their stock for SBC stock. In connection with the merger, AT&T shareholders will receive 0.77942 shares of SBC stock for each share of AT&T stock they own, as well as a one-time cash dividend from AT&T of $1.30 per AT&T share. SBC shareholders will continue to own SBC stock and otherwise will not be affected by the transaction. Upon completion of the transaction, former AT&T shareholders will hold approximately 16% of SBC s outstanding shares. The merger will close after all necessary approvals have been obtained.

Approval Required From the Commission

31. Section 4905.402 of the ORC states that [n]o person may acquire control, directly or indirectly, of a domestic telephone company or a holding company controlling a

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domestic telephone company unless that person obtains the prior approval of [the Commission]. Under Section 4905.402 of the ORC, control is presumed to exist if any person, directly, or indirectly, owns, controls, holds the power to vote, or holds with the power to vote proxies which constitute, twenty percent or more of the total voting power of the domestic telephone company or holding company.

32. Upon consummation of the merger, SBC will indirectly acquire control of two domestic telephone companies (AT&T Ohio and TCG Ohio) and acquire control of a holding company controlling those domestic telephone companies (AT&T Corp.). Thus, the Joint Applicants seek Commission approval of the transaction pursuant to Section 4905.402 of the ORC.

33. Section 4902.402 of the ORC provides that a change in control described in that Section shall be approved by the Commission if such transaction will promote public convenience and result in the provision of adequate service for a reasonable rate, rental, toll, or charge . . . . The merger satisfies this standard.

34. The merger will promote the public convenience for the reasons stated above and for the following reasons:

<u>General Benefits</u>

A. The merger will permit the Joint Applicants Ohio operating subsidiaries to continue providing existing, adequate services at just and reasonable rates, will augment the competitive telecommunications markets within the State of Ohio, and will not adversely affect this Commission s authority to regulate the AT&T and SBC operating subsidiaries subject to the Commission s jurisdiction. In addition, the merger will enhance the abilities of those operating subsidiaries to offer a broad array of existing and emerging telecommunications and information services by bringing together two industry leaders with complementary strengths and by capitalizing on the synergies related to the companies shared values of customer service, innovation, and reliability.

B. The merger will strengthen national security. AT&T in particular is a significant provider of telecommunications and information services to government customers, including the White House, the Department of Homeland Security, the Department of State, the Department of Defense, and the state of Ohio. This transaction will result in a robust, U.S.-owned carrier with the financial resources and technical expertise necessary, not only to continue to provide those services, but also to improve them through even greater investment in innovation that produces cost savings, more reliable services, and more robust capabilities to meet future needs.

C. The merger will increase innovation and investment, which will make existing services more efficient, lead to the more rapid introduction of those services to customers who might otherwise wait years for them, and prompt the development of new services that would otherwise not exist. The combined organization will have greater incentives and ability to invest in research and development and to make available the fruits of those efforts to *all* customers. As a result, residential and small business customers ultimately should enjoy capabilities that once were available only to the largest business and government customers. And once the SBC and AT&T networks are combined, transport will be more efficient, reliability will increase, and the quality of service will be higher. Customers should benefit from such anticipated merger synergies.

D. Other synergies will also result from this transaction, including (a) more rapid and broader deployment of IP-based services; (b) a broader, more efficient deployment of new, innovative services on Multi-protocol Label Switching (MPLS) networks; (c) the enhancement of the combined organization s ability to serve business customers that demand facilities-based, end-to-end services; (d) the closing of product line gaps; (e) the integration of wireless functionalities into large business customer product offerings; and (f) the creation of substantial additional cost savings, including savings in both fixed and variable costs.

Impact on Competition

E. The merger will affirmatively enhance competition, particularly in the provision of services to businesses. Numerous providers stand ready, willing, and able to provide services to business customers, including Sprint, MCI, Focal, Broadwing, XO, NuVox, TelCove, and ChoiceOne. If the proposed transaction is consummated, the combined SBC/AT&T organization will be better positioned than either SBC or AT&T standing alone to compete vigorously and effectively with existing providers of telecommunications services to medium and large businesses IXCs, systems integrators, equipment vendors and resellers, network providers, foreign entrants, CLECs, wireless providers, cable companies, and other ILECs across the full range of current and emerging products. The combined organization will be one entity among many engaged in vigorous competition, which will occur not only because of the *number* of competitors, but also because of the diversity of those competitors.

F. The merger will not adversely affect competition not only because the AT&T and SBC operating subsidiaries in Ohio compete with many other service providers, but also because, as separate entities, SBC and AT&T typically sell business services to different sets of business customers. SBC s strength is in the sale of services to small and medium-sized business with a high percentage of their facilities in SBC s 13 in-region states, while AT&T s strength is the sale of services nationwide and globally to large multi-location businesses.

G. The merger will not diminish competition for mass market customers. AT&T made an irreversible pre-merger decision to discontinue actively marketing local and long distance service to residential and small business customers. In addition, the competition for such customers increasingly is coming from cable operators, VoIP providers, and wireless carriers, in addition to traditional competitors such as ILECs and CLECs. For all these reasons, the merger will have no adverse effect on mass market competition. Rather, increased investment and innovation and broader deployment of new services made possible by the merger should benefit mass market customers. SBC and AT&T anticipate that the combined organization will be better able to compete using VoIP than either company standing alone. Prior to its decision to cease actively marketing mass market landline voice service, AT&T had developed a VoIP service, known as AT&T CallVantage Service. By joining together AT&T s VoIP platform and SBC s traditional consumer focus and financial resources behind VoIP, the merger will permit the combined company to deploy VoIP to both business and mass market customers more aggressively and effectively, both in and out of SBC s region.

H. Moreover, the merger will not impede, and should spur, the technological innovation that is making competition for mass market customers more robust. In addition to traditional competitors such as ILECs, CLECs, and cable operators using circuit switched technology, such as Time Warner and Comcast, new technology competitors are coming forward. These include cable-based providers converting to

VoIP and other IP-based services, such as Comcast and Time Warner, and other VoIP providers, such as Vonage. Cable operators also hold the lead in the provision of high-speed Internet access lines in Ohio. The FCC reported that 36 providers were providing high-speed lines in Ohio as of June 30, 2004, including 13 providers using coaxial cable.(2) Of the nearly 1.2 million high-speed lines provided in Ohio, more than 700,000, or 60%, are provided over cable facilities, while less than one-third are provided using ADSL technology.(3) And more than one million of these high-speed Internet access lines are provided to residential and small business customers.(4)

I. Further, the FCC has reported that as of June 30, 2004 fourteen wireless carriers were serving nearly 6.2 million customers in Ohio, up from 3.2 million customers in December 1999 and a 9% increase from June 2003.(5) As the FCC concluded, [e]vidence continues to mount . . . that consumers are substituting wireless service for traditional wireline communications, and wireless competition has led to a decrease in the number of residential access lines. (6) The Census Bureau has estimated that 5 to 6 percent of all households now have wireless phones only. (7) And with the introduction of 3G services, wireless providers will attract increasing numbers of cord cutters (one-way substitution of wireless for wireline service).

J. Currently, there are dozens of CLECs and numerous other entities competing for customers in the mass market. Indeed, the Commission s website lists 51 certified CLECs in its Competitive Local Phone Company Directory, while the FCC s

(2) High-Speed Services for Internet Access: Status as of June 30, 2004, Table 6 (FCC rel. Dec. 22, 2004).

(3) *Id.* Table 7.

(4) *Id.* Table 11.

(5) Local Telephone Competition: Status as of June 30, 2004, Table 13 (FCC rel. Dec. 2004). The FCC s Local Competition Reports are available at http://www.fcc.gov/wcb/iatd/comp.html.

(6) Ninth Report, *In re Annual Report and Analysis of Competitive Market Conditions With Respect to Commercial Mobile Services*, FCC 04-216, ¶ 213 (FCC rel. Sept. 28, 2004).

(7) *Id.* n.575.

most recent Local Competition Report included data from 21 CLECs providing service in Ohio as of June 30, 2004.(8) The FCC has reported that, as of June 30, 2004, CLECs served nearly one million access lines in Ohio, or 15% of total access lines, up from 4% in December 1999.(9) Two-thirds of these lines are provided to residential and small business customers.(10) In addition, major cable operators which together serve approximately 85 percent of U.S. households have begun aggressively moving to offer VoIP on a nationwide basis, prompting analysts to predict that the growth of VoIP poses a significant competitive challenge to incumbent telephone companies. Wireline Section, Communications Daily, Apr. 13, 2004 (quoting Standard & Poor s). As the Commission is aware from its investigation into the provision of VoIP services (Case No. 03-0950-TP-COI) and the responses to the Commission s VoIP provider questionnaire submitted in that case, a number of providers currently offer VoIP services to Ohio consumers, including Sprint, Vonage, 8x8, and CenturyTel, and other providers, like Bullseye Cable, are currently providing VoIP services on a trial basis.

K. Moreover, AT&T served the mass market primarily via the UNE-P, rather than through the deployment of its own facilities. In its *TRO Remand Order*, however, the FCC determined competitive LECs not only have deployed a significant, growing number of their own switches, often using new, more efficient technologies such as packet switches, but also . . . are able to use those switches to serve the mass market. *TRO Remand Order*, ¶ 199.(11) These facilities-based competitors will continue to compete with SBC and intermodal competitors (such as wireless and cable) in the mass

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(8) Local Telephone Competition: Status as of June 30, 2004, Table 12.

(9) *Id.* at Table 6, Table 7.

(10) *Id.* at Table 11.

(11) Order on Remand, *In re Unbundled Access to Network Elements*, WC Docket No. 04-313, FCC 04-290 (FCC rel. Feb. 4, 2005) (*TRO Remand Order*).

market in Ohio. In light of the existence of a large and growing number and type of competitors in the mass market, the merger will not harm consumers. On the contrary, it will create a stronger company that will be positioned to compete in the mass market with more efficiency, effectiveness, and responsiveness.

L. The merger also raises no competitive issues for Internet, wireless, or international services. With respect to Internet services, in instances where SBC and AT&T subsidiaries compete against each other (the Internet backbone and retail narrowband sector), the level of concentration is low today, and the increase in concentration that would result from this transaction will not be material. AT&T has ceased actively seeking new customers for retail broadband mass market services. Likewise, AT&T has no present or planned facilities-based mobile wireless service operations and resells wireless services to only a few thousand residential consumers under a legacy arrangement that was terminated last year. Finally, SBC has only very limited, resale-based retail international product offerings. Therefore, the combination of SBC and AT&T will not significantly increase concentration in the retail provision of service on U.S. international routes, which are, in any event, today served by numerous large facilities-based and resale providers.

<u>Financial Strength of the Resulting Organization</u>

M. The merger will create an organization that will enjoy enhanced financial health and vigor, which will affirmatively benefit the public. The synergies created by this merger will strengthen the combined organization through reduced costs, increased productivity, and augmented revenues, as the combined organization begins to offer new or better services. The estimated net present value of these operating and capital expense synergies is $15 billion.

N. The synergies created by this merger will strengthen the merged entity by combining the operating and regulatory activities of the organizations, which in turn will reduce costs and increase productivity. These efficiencies will eventually augment revenues.

Employment Outlook

O. The merger of SBC and AT&T will create a much stronger job outlook for the combined organization. One of the results of the recent financial downturn in the telecommunications industry has been the loss of hundreds of thousands of jobs. Neither SBC nor AT&T has been immune. Since 1999, AT&T has reduced its workforce from over 100,000 employees to approximately 47,000. SBC likewise has continued to reduce its workforce. While nearly every corporate merger involves a short-term reduction of jobs because of the need to improve productivity by eliminating redundant and inefficient systems, this merger will position the combined organization for growth, which in time will produce jobs. By creating a new business combination that is stronger than the sum of its parts, the merger of SBC and AT&T will allow the development of new technologies and improvement of its existing services. A strong combined SBC and AT&T will be able to deliver the advanced networks and services required by American businesses to succeed`.

P. Both the unions representing SBC and AT&T workers the Communications Workers of America (CWA) and the International Brotherhood of Electrical Workers (IBEW) have expressed their support of the merger. As Morton

Bahr, the President of the CWA, stated on January 31, 2005, [w]ith the assurance that in this merger, the companies are committed to growing the business, providing quality and universal customer services, and to creating well-paying jobs for American communities, CWA will support the proposed acquisition and urge regulators to give it their approval. Statement of CWA President Morton Bahr, attached hereto as Exhibit K. The IBEW similarly cheered the merger: The IBEW is encouraged by the purchase of AT&T by SBC. We have long maintained that our primary goal for the modern telecommunications industry is the promotion of growth and job opportunities that benefit workers, companies, consumers and communities alike. The joining of forces by two major players in the industry could be a major step toward this goal. Statement of IBEW President Edwin D. Hill, January 31, 2005, attached hereto as Exhibit L.

Corporate Citizenship

Q. As a result of the merger, and the synergies that will enhance the competitive abilities of both companies, AT&T and SBC will continue their traditions of community involvement and good corporate citizenship.

35. The merger will result in the provision of adequate service for a reasonable rate, rental, toll, or charge for the following reasons:

A. The proposed merger will enhance the availability and quality of the service currently offered by the AT&T and SBC operating subsidiaries in Ohio. These subsidiaries, including SBC Ohio, AT&T Ohio, and TCG Ohio, will continue to exist in their current forms upon consummation of the merger. The merger will also ultimately improve the quality and variety of communications services offered to customers. The combined organization of SBC and AT&T will be able to offer new technologies to the consumer and corporate markets more rapidly, to provide businesses with customized, sophisticated, and integrated national and global telecommunications systems, and to create network efficiencies. The combined organization will be able to draw upon the expertise, capabilities, and talents of its combined personnel, employing the best practices learned by each of the previously separate AT&T and SBC organizations and improving the quality and breadth of the services offered.

B. In particular, many of the technological innovations of AT&T Labs, which heretofore have been implemented only for the benefit of AT&T s predominantly high-end, large enterprise customers, are expected to have broader application to the small and medium business and mass market customers that will be served by the combined organization. These include (a) IP-based video services, (b) speech and text technologies for visually- hearing- and speech-impaired customers, (c) fraud reduction and security services, (d) e-commerce capabilities, and (e) service provisioning and repair systems. And the increased financial expenditures of the combined organization in the form of capital expenditures will accelerate the pace at which these new and improved services are deployed.

C. The greater financial strength and stability of the combined organization will enable it to advance its commitment to universal service in Ohio, and to ensure that SBC Ohio satisfies its public utility obligations as determined by Title 49 of the Revised Code, including its carrier of last resort obligations. SBC Ohio will also continue to follow the Commission s guidelines and rules, including but not limited to its Local Service Guidelines, Minimum Telephone Service Standards, and other Commission requirements and orders.

D. The approval of this merger will not impair, compromise, or in any material way alter the Commission s authority to regulate the AT&T and SBC subsidiaries currently operating in Ohio pursuant to this Commission s certifications. Upon completion of the merger, the Commission will retain full authority over the rates, services, and responsibilities of those subsidiaries in accordance with applicable law to the same extent that it does today.

36. The merger will be transparent and seamless for the customers of the operating subsidiaries of SBC and AT&T. The merger is merely a change of control at the holding company level and does not affect the AT&T subsidiaries status as subsidiaries of AT&T, or the SBC subsidiaries status as subsidiaries of SBC, and as regulated providers of telecommunications services in Ohio. The merger will have no immediate or negative effect on the customers of AT&T s operating subsidiaries in Ohio, and will not affect the rates, terms and conditions under which those subsidiaries provide service. Nor will the merger in any way adversely affect the Commission s authority to regulate the AT&T operating subsidiaries subject to the Commission s jurisdiction.

37. Therefore, the Commission should approve the Joint Application in an expeditious manner without a hearing. In previous cases, some of which involved the largest IXCs in the State, the Commission granted, in a matter of weeks and without a hearing, applications for approval of mergers of holding companies having subsidiaries that are existing Ohio utilities. *E.g.*, *In re McCaw Cellular Communications, Inc.*, Case No. 93-1446-TP-UNE (Finding and Order, Sept. 16, 1993); *In re MCI Telecommunications Corp.*, Case No. 93-1730-TP-UNC (Finding and Order, Oct. 23, 1993). In the *McCaw Cellular* case, the Commission approved the application in sixteen days without a hearing because no reasonable argument

could be made that AT&T s acquisition of control of McCaw would prevent McCaw s subsidiaries or AT&T s subsidiaries from continuing to operate in Ohio. Similarly, no reasonable argument can be made that a merger between SBC and AT&T will prevent AT&T s Ohio subsidiaries from continuing to serve Ohio customers under Commission supervision. Therefore, the Commission should issue an order approving this Application promptly.

Request for Waiver of Rule 4901:1-6-08(A)

38. Rule 4901:1-6-08(A) of the Administrative Code provides: An ILEC cannot establish a telephone affiliate that competes with the tier one telecommunication service(s) the ILEC offers in its traditional service territory. Upon consummation of the transaction between SBC and AT&T, AT&T s operating entities in Ohio will become affiliates of SBC Ohio, SBC s ILEC subsidiary in Ohio. To the extent that Rule 4901:1-6-08(A) could be interpreted to apply to the transaction, the Joint Applicants request that the Commission waive that rule for a period of one year or, for customers of AT&T s subsidiaries to whom it applies, until the expiration of any current term contract a customer may have with an AT&T subsidiary in Ohio, whichever is later.

39. Pursuant to Rule 4901:1-6-06 of the Administrative Code, [t]he commission may waive any provision of Chapter 4901:1-6 of the Administrative Code, for good cause shown or upon its own motion. Good cause exists for waiver of Rule 4901:1-6-08(A). As explained above, the merger will promote public convenience and result in the provision of adequate service for a reasonable rate, rental, toll or charge. However, the structure of the merger as set forth in the Agreement and Plan of Merger does not contemplate immediate integration of the SBC and AT&T operating subsidiaries, and requiring such integration would disrupt current customer relationships. Temporarily waiving Rule 4901:1-6-08(A), to the extent that rule

applies, for a period of one year (or until the expiration of existing term contracts) will ensure that the public benefits of the merger redound to Ohio and its consumers, while allowing the Joint Applicants sufficient time to either bring their operations into compliance with the Rule or seek a permanent waiver of the Rule.(12)

Related Governmental Filings

40. In addition to filings with the Commission, SBC and AT&T are taking steps to satisfy the requirements of other governmental entities with respect to the merger. For example, the Federal Communications Commission (FCC) will undertake a detailed review of the merger. In addition, the Department of Justice will conduct its own review of the competitive aspects of this transaction pursuant to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and the rules promulgated thereunder.

Submitted Exhibits

41. Attached hereto is a Table of Exhibits submitted by the Joint Applicants in support of this Joint Application. Each of said Exhibits is incorporated herein by reference and filed herewith.

WHEREFORE, the Joint Applicants request the Commission consent to and approve the transfer of ownership of AT&T as contemplated by the Agreement and Plan of Merger, and grant the waiver requested herein.

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(12) The Joint Applicants note that Rule 4901:0-6-08(A) appears to be inconsistent with 47 U.S.C. § 253(a), which states that [n]o State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate or intrastate telecommunications service. By seeking this waiver, the Joint Applicants do not concede the validity of the rule.

Respectfully submitted,

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Table of Exhibits

Exhibit A: Copy of any superseded tariff sheets & price lists

Exhibit B: Copy of revised tariff sheets & price lists

Exhibit C: Description of and rationale for proposed tariff changes

Exhibit D: Certification from Ohio Secretary of State as to party s proper standing

Exhibit E: List of Names, Addresses, and Phone Numbers of Officers and Directors

Exhibit F: Customer Notice

Exhibit G: List of Ohio exchanges specifically involved or affected

Exhibit H: SBC Annual Report

Exhibit I: AT&T Annual Report

Exhibit J: Agreement and Plan of Merger

Exhibit K: Statement of CWA President Morton Bahr

Exhibit L: Statement of IBEW President Edwin D. Hill

Exhibit A

Copy of Superseded Tariff Sheets

No tariff sheets will be superseded as a result of the merger. The merger will be transparent and seamless for the customers of the operating subsidiaries of SBC and AT&T in Ohio.

Exhibit B

Copy of Revised Tariff Sheets

No tariff sheets will be revised as a result of the merger. The merger will be transparent and seamless for the customers of the operating subsidiaries of SBC and AT&T in Ohio.

Exhibit C

Description of and Rationale for Tariff Changes

No tariff changes will be made as a result of the merger. The merger will be transparent and seamless for the customers of the operating subsidiaries of SBC and AT&T in Ohio.

Exhibit D

Certification from Ohio Secretary of State as to Parties Proper Standing

Exhibit E

Officers and Directors

As a result of the merger, SBC Communications, Inc. (SBC) will acquire AT&T Corp. SBC s present directors and officers are listed below:

BOARD OF DIRECTORS

Mr. Edward E. Whitacre, Jr.

SBC Communications Inc.

175 E. Houston Street, Room 110

San Antonio, Texas 78205

Gilbert F. Amelio, Ph.D.

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Mr. Clarence C. Barksdale

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Mr. August A. Busch III

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

The Honorable William P. Clark

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Mr. Martin K. Eby, Jr.

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Mr. James A. Henderson

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Mr. Charles F. Knight

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Ms. Lynn M. Martin

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio. Texas 78205

Mr. John B. McCoy

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Mary S. Metz, Ph.D.

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Toni Rembe, Esq.

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Mr. S. Donley Ritchey

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Ms. Joyce M. Roché

SBC Communications Inc.

175 E. Houston Street, Room 1140

San Antonio, Texas 78205

Dr. Laura D Andrea Tyson

SBC Communications Inc.

175 E. Houston Street

Room 1140

San Antonio, Texas 78205

Ms. Patricia P. Upton

SBC Communications Inc.

175 E. Houston Street

Room 1140

San Antonio, Texas 78205

OFFICERS

[business addresses: all at 175 E. Houston Street, San Antonio, Texas 78205

Edward E. Whitacre, Jr.	Chief Executive Officer
Randall L. Stephenson	Chief Operating Officer
John H. Atterbury	Group President - IP Services
James W. Callaway	Group President
James D. Ellis	Senior Executive Vice President and General Counsel
Karen E. Jennings	Senior Executive Vice President - Human Resources and Communications
James S. Kahan	Senior Executive Vice President - Corporate Development
Richard G. Lindner	Senior Executive Vice President and Chief Financial Officer
Forrest E. Miller	Group President - External Affairs and Planning
John T. Stankey	Senior Executive Vice President and Chief Technology Officer
Rayford Wilkins, Jr.	Group President
Richard C. Dietz	Vice President - Investor Relations
Jonathan P. Klug	Vice President and Treasurer
Joy Rick	Vice President and Secretary
John J. Stephens	Vice President and Controller
Michael J. Viola	Vice President - Corporate Finance
Charles P. Allen	Assistant Treasurer
Wayne A. Wirtz	Assistant Secretary

After consummation of the merger, SBC s officers and directors will remain the same, except that, pursuant to the Merger Agreement, the board of directors will increase by three members, one of which will be David W. Dorman, currently chairman of the board and chief executive officer of AT&T Corp.

Exhibit F

Customer Notice

The changes resulting from the transaction will be transparent to customers and therefore no notice is required in accordance with Ohio Administrative Code § 4901:1-6-14(B)(3).

Exhibit G

List of Affected Ohio Exchanges

The Joint Applicants incorporate the exchanges currently listed in the Ohio tariffs of the SBC and AT&T operating entities in Ohio. No changes to those tariffs are being made as part of this application. The merger will be transparent and seamless for the customers of the operating subsidiaries of SBC and AT&T in Ohio.

Exhibit K

Communications Workers of America

Search This Site

CWA

The Union for the Information Age

Communications Workers of America *AFL-CIO, CLC*

Press Releases

NEWS RELEASE
For Immediate Release
1/31/2005

For More Information:
Jeff Miller or Candice Johnson
CWA Communications, 202-434-1168

Statement by the Communications Workers of America on SBC s Proposed Purchase of AT&T

President Morton Bahr of the Communications Workers of America issued the following statement on SBC s purchase of AT&T. CWA represents 15,000 employees at AT&T and 95,000 at SBC.

SBC s purchase of AT&T makes good business sense, and it could be good news for customers and employees as well as shareholders of both companies. Such a merger creates a strong U.S. competitor in the global telecom marketplace with the resources to substantially advance the rollout of high-speed broadband and other services and drive economic growth and job expansion.

CWA s concern is for the employment security and career opportunity of the employees we represent. In recent years, AT&T has been contracting its business and shedding jobs. With the integration of its operations into SBC, there is now the opportunity for a new strategy that instead focuses on dynamic growth and creation of new services and technologies.

We look forward to discussing the companies plans in more detail as we talk with SBC and AT&T executives in the coming days and weeks.

With the assurance that in this merger, the companies are committed to growing the business, providing quality and universal customer services, and to creating well-paying jobs for American communities, CWA will support the proposed acquisition and urge regulators to give it their approval.

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Exhibit L

For Immediate Release
January 31, 2005

Contact: Jim Spellane
202 728-6014

Statement of the International Brotherhood of Electrical

Workers On SBC Purchase of AT&T

(Washington, DC) International President Edwin D. Hill of the International Brotherhood of Electrical Workers (IBEW) issued the following statement on the purchase by SBC of AT&T. The IBEW currently represents 12,500 workers at SBC and 900 at AT&T.

The IBEW is encouraged by the purchase of AT&T by SBC. We have long maintained that our primary goal for the modern telecommunications industry is the promotion of growth and job opportunities that benefit workers, companies, consumers and communities alike. The joining of forces by two major players in the industry could be a major step toward this goal.

As the telecom market becomes increasingly global in nature, it is imperative that U.S. companies have the ability to compete with anyone. The combined expertise and resources of SBC and AT&T create a company with significant strength in all facets of the industry and that is positioned to become a force in emerging technologies that are in increasing demand.

We pledge to work with management of SBC and AT&T to ensure that this move will bring about a new era of progress for all concerned.

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;text-indent:-10.0pt;">

Cash flows from investing activities:

Sales of short-term investments

51.6

Purchases of short-term investments

(36.4

)

Investments in unconsolidated joint ventures

(.4

)

Change in restricted cash

(1.2

)

.5

Cash provided by investing activities:

13.6

.5

Cash flows from financing activities:

Borrowings of project debt

5.6

58.3

Repayments of project debt

(14.8

)

(7.0

)

Proceeds from exercise of stock options

.1

.3

Tax benefit from exercise of stock options

.1

Minority interest distributions

(.3

)

(.4

)

Cash (used in) provided by financing activities

(9.3

)

51.2

Net decrease in cash and cash equivalents

(5.0

)

(3.6

)

Cash and cash equivalents - beginning of period

7.7

9.0

Cash and cash equivalents - end of period

$

2.7

$

5.4

Supplemental disclosures of cash flow information:

Cash paid during the period for income taxes, net of refunds received	$ 4.7	$ .9

See the accompanying notes to consolidated financial statements.

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CALIFORNIA COASTAL COMMUNITIES, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1 - Basis of Presentation

The accompanying financial statements have been prepared by California Coastal Communities, Inc. and its consolidated subsidiaries (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The Company believes that these unaudited consolidated financial statements reflect all material adjustments (consisting only of normal recurring adjustments) and disclosures necessary for the fair presentation of the results of operations and statements of financial position when read in conjunction with the Financial Statements and Notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 and the current year s previously issued Quarterly Report on Form 10-Q. Intercompany accounts and transactions have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation.

The results for interim periods are not necessarily indicative of the results to be expected for the full year. This report contains forward-looking statements. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties that actual events or results may differ materially from those described herein as a result of various factors, including without limitation, the factors discussed generally in this report.

Note 2 - Significant Accounting Policies

Consolidation of Variable Interest Entities

A Variable Interest Entity (VIE) is created when (i) the equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties or (ii) equity holders either (a) lack direct or indirect ability to make decisions about the entity, (b) are not obligated to absorb expected losses of the entity or (c) do not have the right to receive expected residual returns of the entity if they occur. If an entity is deemed to be a VIE, pursuant to Financial Interpretation FIN No. 46, Consolidation of Variable Interest Entities an interpretation of ARB No. 51 (FIN 46), an enterprise that has the majority of the variability in gains and losses of the VIE is considered to be the primary beneficiary and must consolidate the VIE. FIN 46 was effective immediately for VIEs created after January 31, 2003.

Based on the provisions of FIN 46, the Company has concluded that whenever it options land or lots from an entity and pays a non-refundable deposit, a VIE may be created under condition (ii)(b) and (c) of the previous paragraph. The Company may be deemed to have provided subordinated financial support, which refers to variable interests that will absorb some or all of an entity s expected theoretical losses if they occur. For each VIE created with a significant nonrefundable option fee, the Company will compute expected losses and residual returns based on the probability of future cash flows as outlined in FIN 46. If the Company is deemed to be the primary beneficiary of the VIE, the VIE will be consolidated on the Company s balance sheet.

The Company s exposure to loss as the result of a purchase contract with a VIE is limited to the amount of the non-refundable option deposit, which is generally 5% to 15% of the purchase price, not total assets on the balance sheet of the VIE. Therefore, the Company believes that consolidating the VIE does not reflect the economic realities or risks of owning and developing land. The Company has no material third party guarantees related to these contracts. Creditors of these VIEs, if any, have no recourse against the Company.

As of June 30, 2006, the Company has no deposits with VIEs. See Note 7 Real Estate Matters.

Real Estate

Real estate inventories primarily consists of homes under construction and lots under development and are carried at the lower of cost or fair value less costs to sell. The estimation process involved in the determination of fair value is inherently uncertain since it requires estimates as to future events and market conditions. Such estimation process assumes the Company s ability to complete development and dispose of its real estate properties in the ordinary course of business based on management s present plans and intentions. Economic, market, and environmental conditions may affect management s development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. Accordingly, the ultimate values of the Company s real estate properties are dependent upon future economic and market conditions, and the availability of financing.

The cost of sales of multi-unit projects is generally computed using the relative sales value method. Interest and other carrying costs are capitalized to real estate projects during their development and construction period.

Impairment of Long-Lived Assets

The Company assesses the impairment of real estate inventories and other long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets , which requires that an impaired asset, for which costs cannot be recovered from estimated undiscounted future cash flows, be written down to fair value. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. As provided by SFAS No. 144, impairment is evaluated by comparing an asset s carrying value to the undiscounted estimated cash flows expected from the asset s operations and eventual disposition. If the sum of the undiscounted estimated future cash flows is less than the carrying value of the asset, an impairment loss is recognized based on the fair value of the asset. If impairment occurs, the fair value of an asset for purposes of SFAS No. 144 is deemed to be the amount a willing buyer would pay a willing seller for such asset in a current transaction.

In accordance with SFAS No. 144, in developing estimated future cash flows for impairment testing, the Company has incorporated its own market assumptions including those regarding home prices, infrastructure, home-building costs and financing costs regarding real estate inventories. Additionally, as appropriate, the Company identifies alternative courses of action to recover the carrying value of its long-lived assets and evaluates all likely alternatives under a probability-weighted approach as described in SFAS No. 144.

Earnings Per Common Share

Earnings per common share is accounted for in accordance with SFAS No. 128, Earnings Per Share . Basic earnings per common share is computed using the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is computed using the weighted-average number of common shares outstanding and the dilutive effect of potential common shares outstanding. For the three and six months ended June 30, 2006 and 2005, the average market price of the Company s common stock exceeded the exercise price of outstanding stock options. Therefore, diluted earnings per share includes the dilutive effect of the weighted average number of common shares from potential exercise of approximately 700,000 options.

The table below sets forth the reconciliation of the denominator of the earnings per share calculation (in millions):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Shares used in computing basic earnings per common share	10.2	10.2	10.2	10.2
Dilutive effect of stock options	.3	.7	.3	.7
Shares used in computing diluted earnings per common share	10.5	10.9	10.5	10.9

9

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)). This Statement replaces SFAS 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board (APB) Opinion No. 25. Accounting for Stock Issued to Employees. SFAS 123(R) addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise s equity instruments or that may be settled by the issuance of such equity instruments. SFAS 123(R) eliminates the ability to account for share-based compensation transactions using the intrinsic value method under APB No. 25, and generally would require instead that such transactions be accounted for using a fair-value-based method. The Company adopted SFAS 123(R) in the first quarter of 2006 using the modified prospective method, which requires that compensation is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under SFAS 123 for either recognition or pro forma disclosures. The Company previously adopted the fair value recognition provisions of SFAS 123 in 2003. The adoption of SFAS 123(R) did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets An amendment of APB 29, Accounting for Nonmonetary Transactions (SFAS 153). This statement amends APB No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. This statement was effective beginning in the Company s first quarter of 2006. The adoption of SFAS 153 did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections (SFAS 154). This statement replaces APB Opinion No. 20, Accounting Changes and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 requires retrospective application of changes in accounting principle to prior periods financial statements unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. This statement was effective beginning in the Company s first quarter of 2006. The adoption of SFAS 154 did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows.

In June 2005, the Emerging Issues Task Force (EITF) reached a final consensus on Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights (EITF 04-5). EITF 04-5 affects the consolidation of entities in which a general partner or managing member is presumed to control a partnership or limited liability company. EITF 04-5 was effective for the Company beginning in the first quarter of 2006. The adoption of EITF 04-5 did not have a material impact on the Company s consolidated financial position, results of operations, or cash flows upon initial adoption. EITF 04-5 may materially impact the Company s consolidated financial position, results of operations, or cash flows in future periods should the Company form new limited partnerships or modify existing limited partnerships such that the Company is deemed to control the limited partnership. Under those circumstances, the Company may be required by EITF 04-5 to consolidate the limited partnership.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*, which prescribes a recognition threshold and measurement process for recording in the financial statements uncertain tax positions taken or expected to be taken in a tax return. Additionally, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. The accounting provisions of FIN 48 are effective for reporting periods beginning after December 15, 2006. The Company is currently assessing the impact of the adoption of FIN 48 and its impact on the Company s consolidated financial statements.

Note 3 - Real Estate Inventories

Real estate inventories primarily consist of homes under construction and lots under development in communities in five Southern California counties. At June 30, 2006, real estate inventories include 858 lots and homes under construction, and nine completed homes. Approximately $142.0 million of real estate inventories at June 30, 2006 reflects the 105-acre parcel of land on a mesa north of the Bolsa Chica wetlands (Upper Mesa), which is planned for 356 homes as discussed below. In addition, the balance includes approximately 51 acres nearby which have been offered for dedication to the County of Orange for inclusion in the Harriet M. Weider Linear Park in conjunction with the development of the Upper Mesa, and 51 additional acres which are subject to a conservation easement. The Company capitalizes direct carrying costs including interest and property taxes, as well as direct construction costs, to real estate inventories.

The planned community on the Upper Mesa, known as Brightwater, will offer a broad mix of home choices, averaging 2,850 square feet and ranging in size from 1,700 square feet to 4,100 square feet. The plan also includes 37 acres of open space and conservation area. With 349 homes permitted on 68 acres of the Upper Mesa, the resulting low-density plan equates to approximately five homes per acre, consistent and compatible with the neighboring Huntington Beach communities. In addition, the Company owns land adjacent to the planned Brightwater development, on which it intends to process permits to build seven additional homes which will be included in the Brightwater community. The Company expects to (i) complete grading during the third quarter of 2006, (ii) begin building model homes during the fourth quarter of 2006, (iii) start selling homes during the second quarter of 2007, and (iv) begin delivering homes during the fourth quarter of 2007. However, there can be no assurance in that regard, or as to the absence of further administrative or construction delay.

The estimation process involved in the determination of value is inherently uncertain since it requires estimates as to future events and market conditions. Such estimation process assumes the Company s ability to complete development and disposition of its real estate properties in the ordinary course of business based on management s present plans and intentions. Economic and market conditions may affect management s development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. Accordingly, the amount ultimately realized from such project may differ materially from current estimates and the project s carrying value.

Capitalized interest is allocated to real estate inventories when incurred, and charged to cost of sales when the related property is delivered. Certain information regarding interest follows (in millions):

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
Capitalized interest, beginning of period	$ 6.1	$ 1.7	$ 6.1	$ 1.3
Interest incurred and capitalized	1.1	2.1	2.2	2.6
Charged to cost of sales	(.7)	(0.1)	(1.8)	(0.2)
Capitalized interest, end of period	$ 6.5	$ 3.7	$ 6.5	$ 3.7

Note 4 - Project Debt

In conjunction with the acquisition of single-family residential lots, the Company s homebuilding subsidiary, Hearthside Homes, Inc. and its subsidiaries, enter into construction loan agreements with commercial banks. These loan facilities finance a portion of the land acquisition and the majority of the construction of infrastructure and homes. Each loan facility requires a guaranty of project completion and an environmental indemnity. The loans secured by first trust deeds bear an interest rate of prime plus three-fourths percent (9.0 % at June 30, 2006), and some of these loan facilities have a minimum interest rate ranging from 5.75% to 7.5%. Additional borrowings under these loan facilities totaled $5.6 million during the six months ended June 30, 2006, and consisted primarily of draws on the Lancaster loan and interest on outstanding borrowings. The $14.8 million of repayments during the six months ended June 30, 2006 included full repayment of $8.7 million outstanding under the Rancho Santa Fe facility due in March 2006 and $6.1 million on the Lancaster and Corona loans upon deliveries of homes. During the three and six months ended June 30, 2006, Hearthside Homes, Inc. entered into no new loan facilities. The following amounts were available and outstanding under these loan facilities as of June 30, 2006 and December 31, 2005 ($ in millions):

First Trust Deeds	Amount of Facility	Number of Lots	Maturity Date	Outstanding at June 30, 2006	December 31, 2005
Rancho Santa Fe	$ 15.4		3/27/06	$	$ 8.5
Lancaster	9.5		5/10/06		.2
Rancho Santa Fe	1.8	2	9/13/06	1.8	1.7
Ontario	11.7	26	10/19/06	4.8	4.6
Corona	1.9	4	10/26/06	1.9	1.8
Corona	14.8	35	10/26/06	6.5	7.0
Lancaster	1.0	3	11/17/06	1.0	1.0
Lancaster	10.5	20	11/17/06	2.0	3.6
Corona	41.1	151	1/7/07	19.6	18.8
Beaumont	20.7	102	2/17/07	7.9	7.6
Lancaster	17.7	77	7/1/07	3.2	3.1
				$ 48.7	$ 57.9

Note 5 - Other Liabilities

Other liabilities were comprised of the following (in millions):

	June 30, 2006	December 31, 2005
Accrued pensions and benefits	$ 4.7	$ 4.8
Home warranty reserves	2.2	2.1
Contingent indemnity and environmental obligations	1.5	1.5
Unamortized discount	(.5)	(.5)
	$ 7.9	$ 7.9

Contingent indemnity and environmental obligations primarily reflect reserves before related discount (recorded pursuant to Fresh-Start Reporting) for contingent indemnity obligations for businesses disposed of by former affiliates and unrelated to the Company s current operations.

Home Warranty Reserve

The Company provides a home warranty reserve to reflect its contingent obligation for product liability. The Company generally records a provision as homes are delivered, based upon historical and industry experience, for the items listed in the homeowner warranty manual, which does not include items that are covered by manufacturers warranties or items that are not installed by the Company s employees or contractors. The home warranty reserve activity is presented below (in millions):

	Six Months Ended June 30, 2006	2005
Balance at beginning of period	$ 2.1	$ 1.6
Provision	.2	.1
Payments	(.1)	(.2)
Balance at end of period	$ 2.2	$ 1.5

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Note 6 - Income Taxes

The following is a summary of the tax provision (benefit):

	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Current taxes	$ .2	$	$ .7	$ .1
Deferred taxes	.6	.1	1.5	.2
Reversal of valuation allowance on deferred tax assets				(4.7)
Provision (benefit) for income taxes	$ .8	$ .1	$ 2.2	$ (4.4)

Deferred tax benefits resulting from reductions in the deferred tax asset valuation allowance on NOLs are recorded when the Company concludes that it is more likely than not that it will utilize additional NOLs to offset future taxable income. As a result of the California Coastal Commission s approval of the Company s development plan for the Bolsa Chica Upper Mesa on April 14, 2005, the Company concluded that it is more likely than not that it will utilize all of its deferred tax assets. Therefore, during the six months ended June 30, 2005, the Company recorded a reversal of valuation allowance on post-reorganization NOLs and other deferred tax assets of approximately $4.7 million, which is reflected in the tax benefit. Pursuant to Fresh Start Reporting, also during the six months ended June 30, 2005, a reversal of valuation allowance on federal Pre-reorganization NOLs of approximately $38.5 million was reflected by increasing the Company s capital in excess of par value.

The Internal Revenue Code (the Code) generally limits the availability of NOLs if an ownership change occurs within any three-year period under Section 382. If the Company were to experience an ownership change of more than 50%, the use of all remaining NOLs would generally be subject to an annual limitation equal to the value of the Company s equity before the ownership change, multiplied by the long-term tax-exempt rate. The Company estimates that after giving effect to various transactions by stockholders who hold a 5% or greater interest in the Company, it has experienced a three-year cumulative ownership shift of approximately 44% as of July 31, 2006.

The federal NOLs available as of June 30, 2006 were approximately $122 million. The amount of federal NOLs which expire if not utilized is zero for 2006, 2007 and 2008 and $6 million, $49 million, and $67 million for 2009, 2010 and thereafter, respectively.

In October 1999, in response to an unsolicited written consent from a majority of its stockholders, the Company amended its certificate of incorporation in order to protect the ability of the Company to utilize its tax loss carryforwards. Since the Company s use of its NOLs would be severely restricted if it experiences an ownership change of more than 50%, the Company s majority stockholders requested that the Board of Directors enact the amendments, which were determined to be in the best interest of the Company and its stockholders. The amendments prohibit future purchases of the Company s common stock by persons who would become new 5% holders, and also prohibit current holders of over 5% from increasing their positions, except in certain permissible circumstances which would not jeopardize the Company s ability to use its NOLs. While these amendments reduced the Company s risk of an ownership change occurring due to the acquisition of shares by 5% stockholders, the risk remains that an ownership change could result from the sale of shares by existing 5% stockholders. The Company s Board of Directors evaluates requests to purchase any amounts in excess of 5% of the Company s common stock and authorizes such transactions which are not expected to jeopardize the Company s ability to use its NOLs.

Note 7 - Commitments and Contingencies

Real Estate Matters

The Company is subject to the usual obligations associated with entering into contracts for the purchase of land and improved home sites. The purchase of properties under these contracts is generally contingent upon satisfaction of certain requirements by the sellers, including obtaining applicable property entitlements. The Company also utilizes option contracts with third-party land sellers and financial entities as a method of acquiring land in staged takedowns and minimizing the use of funds from other corporate financing sources. These option contracts also help to manage the financial and market risk associated with land holdings. Option contracts generally require the payment of a non-refundable cash deposit of 5% to 15% of the purchase price for the right to acquire lots over a specified period of time (usually one to two years) at predetermined prices. The Company has the right at its discretion to terminate its obligations under these land purchase and option agreements by forfeiting the cash deposit with no further financial responsibility. As of December 31, 2005, the Company had no land option deposits. As of June 30, 2006, the Company had one $25,000 refundable land option deposit. In addition, our unconsolidated Oxnard joint venture has land deposits (discussed below).

In February 2003, the Company entered into two option contracts to acquire land adjacent to the City of Oxnard in Ventura County, California aggregating approximately 168 acres. The Company is in the process of developing a land plan for the area, which also includes an additional 149 acres owned by other landowners, with the intention of entitling the property for residential development and annexing it into Oxnard. During October 2003, the Company entered into a limited liability company joint venture agreement with a major financial partner to pursue the Oxnard development opportunity. The Company assigned the land purchase option contracts to the Oxnard limited liability company. Hearthside Homes, Inc., the Company s homebuilding subsidiary, is the managing member of the Oxnard joint venture, and made an initial contribution of $500,000. The non-managing member also made an initial contribution of $500,000 to the joint venture and, as of December 31, 2005, had made an aggregate of $4 million of first tier additional contributions. The members have agreed to provide a second tier of additional capital contributions of up to $2 million, as necessary, to complete the business plan. For contributions in excess of $5 million, the first $500,000 is to be contributed equally by the Company and the Company s partner. At the Company s discretion, the Company could continue to contribute equally to the next $500,000. Thereafter, the next $1 million is to be contributed equally between the members. During the fourth quarter of 2005 and the first six months of 2006, the members each contributed approximately $160,000 and $440,000, respectively, of the additional $2 million. The Company s total investment in the venture as of June 30, 2006 is $1.1 million. The Company expects to make additional aggregate capital contributions of approximately $700,000 to the joint venture during the next 15 months, bringing the Company s total expected investment in the venture to $1.8 million.

The Company has outstanding performance and surety bonds, for the benefit of city and county jurisdictions, related principally to its obligations for site improvements at various projects. The Company does not believe that draws upon these bonds, if any, will have a material effect on the Company s financial position, results of operations or cash flows.

Legal Proceedings

There are various lawsuits and claims pending against the Company and certain subsidiaries. In the opinion of the Company s management, ultimate liability, if any, will not have a material adverse effect on the Company s financial condition or results of operations.

See Note 5 for a discussion of other contingencies.

Corporate Indemnification Matters

The Company and its former affiliates have, through a variety of transactions effected since 1986, disposed of several assets and businesses, many of which are unrelated to the Company s current operations. By operation of law or contractual indemnity provisions, the Company may have retained liabilities relating to certain of these assets and businesses. There is generally no maximum obligation or amount of indemnity provided for such liabilities. A portion of such liabilities is supported by insurance or by indemnities from certain of the Company s previously affiliated companies. The Company believes its consolidated balance sheet reflects adequate reserves for these matters.

Note 8 - Subsequent Event

On August 1, 2006, the Company obtained a commitment from KeyBank to underwrite a $125 million five-year, senior secured term loan to finance the distribution of a special dividend of between $11 and $13 per share. On June 27, 2006, the Company announced that this special dividend is expected to be paid to the holders of the Company s common stock by the end of September 2006. The term loan will be secured by a pledge of the stock of the Company s material subsidiaries, including the subsidiary that owns the Bolsa Chica mesa. KeyBank is also in the process of syndicating a $100 million three-year, Senior Secured Revolving Credit Facility (Facility) to finance development and construction costs for the Company s Brightwater project. The Facility will be secured by a first trust deed on the Bolsa

Chica mesa and includes financial covenants that require the Company to, among other requirements, meet compliance tests for budgeted Brightwater revenue and cost amounts, maintain an interest reserve, maintain a minimum net worth of $100 million plus 25% of future earnings, and not exceed certain leverage ratios. The term loan is expected to bear interest at the Company s option at either Libor plus 275 basis points or Prime plus 25 basis points and the revolver will bear interest at the Company s option at either Libor plus 200 basis points or Prime minus 25 basis points. The Company expects both of these financing transactions to be completed within the next 30 days; however, there can be no assurances that there will not be delays or that the transactions will be completed and the special dividend distribution will be made.

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ITEM 2 - MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview of California Coastal Communities, Inc

We are a residential land development and homebuilding company with properties owned or controlled in six Southern California counties (Los Angeles, Orange, Riverside, San Bernardino, San Diego and Ventura). Our principal activities include:

- obtaining zoning and other entitlements for land we own or control through purchase options or joint ventures;
- improving the land for residential development; and
- designing, constructing and selling single-family homes in Southern California.

Once our residential land is entitled, we may build homes, sell unimproved land to other developers or homebuilders, sell improved land to homebuilders, or participate in joint ventures with other developers, investors or homebuilders to finance and construct infrastructure and homes. The majority of these homes are designed to appeal to move-up homebuyers and are generally offered for sale in advance of their construction. During the next 12 months, we will focus our primary efforts to:

- complete grading and begin building model homes for our Brightwater project located on 105 acres of the Bolsa Chica mesa in Orange County, California in accordance with the Coastal Development Permit for 349 homes issued by the California Coastal Commission in December 2005;
- complete the entitlement process for a 168-acre joint venture project near Oxnard, California; and
- increase deliveries, revenues and profitability of our homebuilding operations throughout Southern California.

However, we are also considering other strategic opportunities as discussed below; and there can be no assurance that we will accomplish, in whole or in part, all or any of these strategic goals.

Our total revenues for the three months ended June 30, 2006 and 2005 were $18.8 million and $3.1 million, respectively, and $46.7 million and $9.6 million for the six months ended June 30, 2006 and 2005, respectively. For the three months ended June 30, 2006 and 2005, we delivered 28 and four homes, respectively, and for the six months ended June 30, 2006 and 2005, we delivered 77 and 14 homes, respectively. Our total assets as of June 30, 2006 and December 31, 2005 were $324.7 million and $330.4 million, respectively. Over the last 11 years, we have delivered over 1,900 homes to families throughout Southern California.

We were formed in 1988 and our executive offices are located at 6 Executive Circle, Suite 250, Irvine, California 92614. Our telephone number is (949) 250-7700.

Strategic Alternatives

Our Board of Directors and management have always been and continue to be committed to enhancing value for all stockholders. In that regard, we continue to evaluate strategic alternatives. From time to time we have considered the various strategic alternatives available to us with respect to our businesses, assets, operations and available cash. We have engaged investment bankers and other advisors for this purpose, with a view towards assessing alternatives which would enhance the value of our current businesses, create additional business opportunities, or otherwise maximize the value of our company for our stockholders. Included in this process has been an exploration of merger, acquisition and disposition possibilities; analysis of equity and debt financings; open market and other repurchases of our stock; dividends and other distributions to our stockholders; and combinations of these alternatives.

Prior to obtaining the Coastal Development Permit for our Brightwater project in December 2005, we have historically maintained a minimal amount of leverage. We currently have $48.7 million of project-specific debt against

$250 million of book equity and a $326 million equity market capitalization as of June 30, 2006. The Bolsa Chica mesa is currently unencumbered by debt; however, if the financing transactions described below and in Note 8 to the Financial Statements are completed, the Bolsa Chica mesa will be encumbered by a first trust deed.

On June 27, 2006, we announced our plan to distribute a special tax-advantaged dividend of $11 to $13 per share by the end of September 2006. We expect this special dividend to be treated as a return of capital to the extent of each stockholder s tax basis in our stock. Our Board of Directors will declare the dividend amount, record date and payment date upon completion of the KeyBank financing transactions discussed below and in Note 8.

On August 1, 2006, we obtained a commitment from KeyBank to underwrite a $125 million five-year, senior secured term loan to finance the special dividend payment. The term loan will be secured by a pledge of the stock of our material subsidiaries, including the subsidiary that owns the Bolsa Chica mesa. KeyBank is also in the process of syndicating a $100 million three-year, senior secured revolving construction loan for our Brightwater project, which will be secured by a first trust deed on the Bolsa Chica mesa. The term loan is expected to bear interest at the Company s option at either Libor plus 275 basis points or Prime plus 25 basis points and the revolver will bear interest at the Company s option at either Libor plus 200 basis points or Prime minus 25 basis points. We expect both of these financing transactions to be completed within the next 30 days; however, there can be no assurances that there will not be any delays or that the transactions will be completed and the special dividend distribution will be made.

As we continue to develop Brightwater, we will also continue to evaluate any other available strategic alternative that will maximize value to our stockholders.

Our Current and Future Homesites

We currently have on-going Southern California homebuilding projects in:

- Riverside County near the cities of Corona and North Corona, and in the City of Beaumont;
- San Bernardino County in the City of Ontario;
- Northern Los Angeles County in the City of Lancaster;
- San Diego County in the Rancho Santa Fe area; and
- Orange County in the Huntington Beach area.

We began grading our Brightwater development project during June 2006 and plan to process permits for seven homes on adjacent parcels, which would bring the total unit count up to 356. The following chart describes our current projects, their location and our lot inventories as of June 30, 2006:

Project	**Location**	**Lot Inventory**
Chandler Ranch	North Corona	39
Alisal at Ontario	Ontario	26
Woodhaven	Beaumont	102
Hearthside Lane	Corona	151
	Subtotal Inland Empire	318
Alisal at Lancaster	Lancaster	23
Lancaster II	Lancaster	73
Quartz Hill	Lancaster	77
	Subtotal - Lancaster	173
Cancion	Rancho Santa Fe	20
Brightwater	Bolsa Chica	356
	Total - All Projects	867

These homebuilding projects are currently expected to generate cash flows and gross operating margins through mid-2010. Up to approximately 555 additional single-family lots would be available for homebuilding operations if we obtain entitlements for our Oxnard project; however, the exact number of homes will depend on the final outcome of the entitlement process.

Brightwater at Bolsa Chica

The Bolsa Chica upper mesa is the largest property in our portfolio, representing approximately 44% of our total assets as of June 30, 2006. The Bolsa Chica upper mesa is one of the last large undeveloped coastal properties in Southern California, and is located in Orange County, approximately 35 miles south of downtown Los Angeles. Bolsa Chica is bordered on the north and east by residential development in the City of Huntington Beach and Huntington Harbor, to the south by open space and the Bolsa Chica wetlands, and to the west by open space, Pacific Coast Highway, Bolsa Chica State Beach, and the Pacific Ocean. Our holdings include 68 acres of developable land on the Bolsa Chica upper mesa planned for a residential community known as Brightwater, 37 acres of open space and conservation area in the planned community, five acres in the City of Huntington Beach which are currently zoned agricultural, and approximately 104 non-developable acres on, or adjacent to, the Huntington Mesa. Approximately 51 acres of land on the Huntington Mesa have been offered for dedication to the County of Orange for inclusion in the Harriet M. Weider Linear Park in conjunction with the development of Brightwater and an additional 51 acres are subject to a conservation easement. We are analyzing development alternatives for the 5-acre Huntington Beach parcel and expect to submit a proposed site plan to the City of Huntington Beach later this year.

On December 15, 2005, we received a permit from the California Coastal Commission for development of the 349-home Brightwater residential community, which will offer a broad mix of home choices averaging 2,850 square feet and ranging in size from 1,700 square feet to 4,100 square feet. In addition, we own land adjacent to the planned Brightwater development in the City of Huntington Beach, for which we intend to process permits to build seven additional homes which would be included in the Brightwater community. We began grading the Brightwater development this past June and we currently expect to:

- complete grading during the third quarter of 2006,
- begin building model homes during the fourth quarter of 2006, and
- start selling homes during the second quarter of 2007;

however, there can be no assurance in that regard, or as to the absence of any delays.

Our Brightwater plan also includes 37 acres of open space and conservation area. With 356 homes on 68 acres of the upper mesa, the resulting low-density plan equates to approximately five homes per acre, consistent and compatible with the neighboring Huntington Beach communities.

During the first quarter of 2005, following the Coastal Commission s conditional approval of our permit to develop Brightwater, we concluded that it is more likely than not that we will utilize all of our deferred tax assets, including net operating losses, to offset future taxable income. As a result, we recorded a $4.7 million reversal of valuation allowance on post-reorganization net operating losses and other deferred tax assets and a $38.5 million reversal of valuation allowance on federal pre-reorganization net operating losses. See Note 6 in our Consolidated Financial Statements.

We used the following facts and assumptions in evaluating the value that we expect to receive from the Brightwater development project:

- The Brightwater coastal development permit provides for 349 homes aggregating approximately 995,000 square feet.
- We own land adjacent to Brightwater in the City of Huntington Beach, for which we intend to process permits to build seven additional homes which would be included in the Brightwater community.
- Development at Brightwater is projected to take approximately four to six months for infrastructure, approximately eight months to build 14 model homes, and two to three years for home construction.

- We are currently planning to: (i) complete grading during the third quarter of 2006, (ii) begin building model homes during the fourth quarter of 2006, (iii) begin selling homes during the second quarter of 2007, and (iv) begin delivering homes in the fourth quarter of 2007.

- As of January 2006, new home prices approximated $650 per square foot, including view and other premiums, in the local residential market (coastal Huntington Beach).

- The finished lot component of home prices ranges from 60% to 65%.

- Costs to improve the lots from their raw condition to finished lots, including building permits and city fees, approximate $140,000 per lot.

- While demand continues to exceed the supply of housing in coastal Orange county, the volume of home sales has slowed during the first half of 2006 and pressure for continued appreciation of home prices appears to have subsided.

The estimation process involved in the determination of value is inherently uncertain because it requires estimates as to future events and market conditions. This estimation process assumes our ability to complete development and disposition of our real estate properties in the ordinary course of business based on management s present plans and intentions. Economic, market, and environmental conditions may affect our development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. The development of Brightwater is dependent upon various economic factors. Accordingly, the amount ultimately realized from the Brightwater project may differ materially from our current estimates and the project s carrying value.

Oxnard Land Development - Unconsolidated Joint Venture

In February 2003, we entered into two option contracts to acquire land adjacent to the City of Oxnard in Ventura County, California aggregating approximately 168 acres. We are in the process of developing a land plan for the area, which also includes an additional 149 acres owned by other landowners, with the intention of entitling the property for residential development and annexing it into Oxnard. We currently expect the residential development plan to include approximately 800 single-family detached lots and approximately 750 attached family residential units (townhomes, condominiums, and apartments); however, these numbers are subject to change during the course of the entitlement process. Approximately 555 of the single-family lots and 490 of the attached units would be developed on the 168 acres of optioned land that we currently expect to purchase. The option contracts give us two years, plus up to three additional years through the exercise of extensions, to complete these entitlement activities before purchasing the land. We have the right to terminate these option agreements by forfeiting the cash deposits. We are striving to obtain approval of our plan from the Oxnard City Council by the end of 2006 and approval of annexation into the City of Oxnard from the Local Agency Formation Commission in the second half of 2007; however, delays could be encountered. We have exercised four six-month extensions, extending the current closing date for the option contracts to February 2007.

During October 2003, we entered into a limited liability company joint venture agreement with a major financial partner to pursue the Oxnard development opportunity. We assigned the land purchase option contracts to the Oxnard limited liability company. Hearthside Homes, Inc., our homebuilding subsidiary, is the managing member of the Oxnard joint venture, and made an initial contribution of $500,000. The non-managing member also made an initial contribution of $500,000 to the joint venture and, as of December 31, 2005, had made an aggregate of $4 million of first tier additional contributions. The members have agreed to provide a second tier of additional capital contributions of up to $2 million, as necessary, to complete the business plan. For contributions in excess of $5 million, the first $500,000 is to be contributed equally by us and our partner. At our discretion, we could continue to contribute equally to the next $500,000. Thereafter, the next $1 million is to be contributed equally between us. During the fourth quarter of 2005 and the first six months of 2006, we each contributed approximately $160,000 and $440,000, respectively, of the additional $2 million. Our total investment in the venture as of June 30, 2006 is $1.1 million. We expect to make additional aggregate capital contributions of approximately $700,000 to the joint venture during the next 15 months, bringing our total expected investment in the project to $1.8 million. After payment of a 10% preferred return on invested capital to us and our partner, first tier profits are generally allocated 75% to our partner and 25% to us and second tier profits and losses over $5 million are generally allocated on a 50/50 basis. The first $5 million of losses are generally allocated 80% to our partner and 20% to us. While we exert a large degree of influence over the joint venture, our partner does have

various substantive participating rights such as approval rights with regard to the majority of business decisions, including approval of project budgets.

Homebuilding

We acquired no single-family residential lots during the first six months of 2006. Although home prices in Southern California increased dramatically over the last few years, we have not seen price appreciation in our markets in the first half of 2006, and expect modest, if any, increases over the next year. We have noticed a number of large national homebuilders offering various buyer incentives and there is also a possibility of price decreases over the next 12 months. We delivered 28 homes during the second quarter of 2006, compared to only four deliveries during the comparable period in 2005. The record rainfall during the fourth quarter of 2004 and the first quarter of 2005 negatively impacted our construction schedule and contributed to our lower number of home deliveries in the second quarter of 2005.

Our homebuilding projects are described below:

	Location	Land Acquisition	Commenced Construction	Commenced Sales	Deliveries Quarter Ended June 30, 2006	2005
Completed Projects	Various	n/a	n/a	n/a		4
Active Projects						
Chandler Ranch	North Corona	2004	2005	2005	6	
Cancion	Rancho Santa Fe	2003-2005	2005	2005	6	
Alisal at Lancaster	Lancaster	2004	2004	2005	16	
Alisal at Ontario	Ontario	2005	2005	2006		
Woodhaven	Beaumont	2005	2005	2006		
Hearthside Lane	Corona	2005	2005	2006 (a)		
Quartz Hill	Lancaster	2005	2006	2006 (a)		
Brightwater	Bolsa Chica	1970	2006	2007 (a)		
				Total Deliveries	28	4

(a) Pending

Rancho Santa Fe. In October 2003, we entered into an agreement to acquire 32 lots in a luxury golf community known as Crosby Estates in the Rancho Santa Fe area of San Diego County in California. We acquired the lots during the period from October 2003 to March 2005. During 2005, two model homes averaging approximately 3,370 square feet were completed and six homes were delivered at an average price of $1,223,000. We delivered six homes during the first half of 2006 at an average price of $1,359,000. During July 2006, six additional homes were delivered at an average price of $1,421,000, and as of July 31, 2006, eight homes are in escrow at an average price of $1,420,000, two homes are completed and held for sale, and four additional homes are under construction and held for sale.

Lancaster. We acquired 104 lots in the City of Lancaster in northern Los Angeles County during May 2004. We began construction of model homes averaging approximately 2,800 square feet during the third quarter of 2004 and opened for home sales in January 2005. During 2005, we delivered 55 homes at an average price of $406,000. We delivered 26 homes during the first half of 2006 at an average price of $424,000, delivered an additional nine homes during July and, as of July 31, 2006, seven homes are in escrow at an average price of $488,000, and six homes are completed models or are under construction and held for sale. In April 2005, we acquired an additional 73 unentitled lots in Lancaster. We are completing the entitlement process and plans for the project and expect to begin construction during 2007.

In December 2005, we acquired 77 additional lots in an area known as Quartz Hill in the City of Lancaster. The homes in this community will be on 10,000 square foot lots and will average 3,642 square feet. Construction of models began in May 2006 and we opened for sales during July 2006. As of July 31, 2006, three model homes and the first 13 production homes are under construction, and six homes have been released for sale.

Corona. We acquired 83 lots in North Corona in May 2004. Following construction of infrastructure, during April 2005, we began construction of homes averaging 3,160 square feet. We opened for sales during the third quarter of 2005 and delivered 44 homes during the first half of 2006 at an average price of $607,000 and delivered two additional homes in July. As of July 31, 2006, five homes are in escrow at an average price of $595,000, six homes are completed and held for sale, and six additional homes are under construction and have been released for sale.

During April 2005, we acquired 151 lots in Corona. Following construction of infrastructure, construction of homes averaging 3,600 square feet on lots of approximately 7,200 square feet is expected to begin during the third quarter of 2006.

Ontario. During April 2005, we acquired 26 lots in the City of Ontario in Riverside County, California. This small community of homes, planned to average 3,380 square feet, is an infill site situated very close to the projects we recently completed in the City of Chino. Construction began during the fourth quarter of 2005, and we opened for sales during March 2006. As of July 31, 2006, four homes are in escrow at an average price of $690,000, and nine additional homes are under construction and have been released for sale.

Beaumont. We acquired 102 lots in the City of Beaumont during the third quarter of 2005. Following construction of infrastructure, construction of homes averaging 2,500 square feet began during the first quarter of 2006, and sales commenced during March 2006. As of July 31, 2006, 14 homes are in escrow at an average price of $403,000 and 26 additional homes are under construction and have been released for sale.

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Outlook

The housing market in Southern California has slowed during the first half of 2006. For the second quarter of 2006, our net new orders decreased 57% to 16 homes from 37 homes for the second quarter of 2005. The decrease in net new orders reflects the industry-wide slowdown and is comparable to the 55% decrease in the first quarter of 2006 (29 homes for the first quarter of 2006 compared with 64 homes for the first quarter of 2005). At the same time, backlog as of quarter end decreased 48% (49 as of June 30, 2006 compared with 94 as of June 30, 2005), while the value of homes in backlog decreased only 24% to $39.8 million from $52.3 million. Although the homebuilding business historically has been cyclical, it has not undergone an economic down cycle in a number of years. Further, during 2005, home prices rose significantly in all of our markets. This has led some people to assert that the prices of land, new homes and the stock prices of homebuilding companies may be inflated and may decline further if the demand for new homes weakens further. A decline in the prices for new homes could adversely affect both our revenues and margins. A decline in our stock price could make raising capital through stock issuances more difficult and expensive.

We believe this slowdown is attributable to an overall softening of demand for new homes as well as an oversupply of homes available for sale. We attribute the reduction in demand to reduced affordability of new homes due to rapid price increases over the last six years and concerns on the part of prospective home buyers about the future direction of home prices and interest rates, and their ability to sell existing homes. In addition, speculators and investors are no longer helping to fuel demand. We try to avoid selling homes to speculators and build very few homes without having a signed agreement of sale. Nonetheless, we have been impacted by an overall increase in the supply of homes available for sale in our markets as speculators attempt to sell the homes they previously purchased or cancel contracts for homes under construction. At the same time, many of the large national homebuilders operating in our markets are attempting to reduce their inventories by offering incentives and/or lowering prices.

In addition, based on the high cancellation rates reported by other builders, and on the increased cancellation rates we have experienced, non-speculative buyer cancellations are also adding to the supply of homes in the marketplace. Our cancellations increased to five and 17 in the three and six months ended June 30, 2006, compared to none in the comparable periods of 2005.

Despite this slowdown, we remain cautiously optimistic about the future growth of our business. The long term outlook for homebuilding in Southern California remains strong due to the continuing regulation-induced constraints on lot supplies. We have traditionally employed a conservative approach to managing our real estate inventories and believe we are well-positioned to withstand the effects of the market downturn as it unfolds.

There can be no assurance regarding the duration of the current slowdown of the Southern California residential real estate market. In particular, (i) the significant increases in home prices over the last six years and the related decline in the affordability of new homes in Southern California, (ii) the state of the national economy, continued increases in interest rates by the Federal Reserve Board and the possibility of a recession in the future, and (iii) the volatility in the stock market, collectively may exert recessionary pressures on the California economy and may have further negative impacts on the Southern California housing market.

Critical Accounting Policies

In the preparation of the Consolidated Financial Statements, we applied accounting principles generally accepted in the United States of America. The application of generally accepted accounting principles may require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying results. Listed below are those policies and estimates that we believe are critical and require the use of complex judgment in their application. In particular, our critical accounting policies and estimates include the evaluation of the impairment of long-lived assets and the evaluation of the probability of being able to realize the future benefits indicated by our significant federal tax net operating losses, as discussed further in Notes 2 and 6 to the Consolidated Financial Statements.

Impairment of Long-Lived Assets

We assess the impairment of real estate inventories and other long-lived assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which requires that an impaired asset, for which costs cannot be recovered from estimated undiscounted future cash flows, be written down to fair value. Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. As provided by SFAS No. 144, impairment is evaluated by comparing an asset s carrying value to the undiscounted estimated cash flows expected from the asset s operations and eventual disposition. If the sum of the undiscounted estimated future cash flows is less than the carrying value of the asset, an impairment loss is recognized based on the fair value of the asset. If impairment occurs, the fair value of an asset for purposes of SFAS No. 144 is deemed to be the amount a willing buyer would pay a willing seller

for such asset in a current transaction. These assets are carried at cost, unless the carrying amount of the parcel or subdivision is determined not to be fully recoverable, in which case the impaired real estate is written down to fair value. Given the significance of the carrying value of real estate inventories, the application of SFAS No. 144 in evaluating any potential impairment is critical to our consolidated financial statements, as discussed further in Note 2 to the Consolidated Financial Statements.

The Bolsa Chica property is our largest asset. Prior to the December 2005 receipt of our Brightwater permit, the property was included in land held for future development or sale. In December 2005, we sold approximately 146 acres of the property to the State. Beginning in December 2005, the remaining portion consisting of approximately 214 acres is included in real estate inventories.

In accordance with SFAS No. 144, in developing estimated future cash flows for impairment testing, we incorporated our own market assumptions including those regarding home prices, infrastructure, home-building costs, and financing costs regarding real estate inventories. Additionally, as appropriate, we identify alternative courses of action to recover the carrying value of our long-lived assets and evaluate all likely alternatives under a probability-weighted approach as described in SFAS No. 144.

The estimation process involved in the determination of value is inherently uncertain because it requires estimates as to future events and market conditions. Such estimation process assumes our ability to complete development and disposition of our real estate properties in the ordinary course of business based on management s present plans and intentions. Economic, market, and environmental conditions may affect management s development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. The development of our Brightwater project is dependent upon various economic factors. Accordingly, the amount ultimately realized from such project may differ materially from current estimates and the project s carrying value.

Basis of Consolidation

Certain of our wholly-owned subsidiaries are members in joint ventures involved in the development and sale of residential projects and residential loan production. Our consolidated statements include our accounts and all of our majority-owned and controlled subsidiaries and joint ventures. The financial statements of joint ventures in which we generally have a controlling or majority economic interest (and thus are controlled by us) are consolidated with our financial statements. Minority interest represents the equity interest of our joint venture partner for one consolidated venture. Our investments in unconsolidated joint ventures are accounted for using the equity method when we do not have voting or economic control of the venture operations.

Income Taxes

We account for income taxes on the liability method. Deferred income taxes are determined based on the difference between the financial statement and tax bases of assets and liabilities. The liability method requires an evaluation of the probability of being able to realize the future benefits indicated by deferred tax assets, such as tax net operating losses. A valuation allowance related to the deferred tax asset is recorded when it is more likely than not that some portion or all of the deferred tax asset will not be realized. Given the significance of our historical federal tax net operating losses, as discussed in Note 6 to the Consolidated Financial Statements, the application of our policy in evaluating the expected future benefit of net operating losses is critical. In applying those policies, estimates and judgments affect the amounts at which certain assets and liabilities are recorded. We apply our accounting policies on a consistent basis. As circumstances change, they are considered in our estimates and judgments, and future changes in circumstances could result in changes in amounts at which assets and liabilities are recorded.

We remain subject to the general rules of Section 382, which limit the availability of net operating losses if an ownership change occurs. If we were to experience another ownership change, the amount of net operating losses available would generally be limited to an annual amount equal to (i) the value of our equity immediately before the ownership change, multiplied by the long-term tax-exempt rate (4.45% as of July 2006) plus (ii) recognized built-in-gains, defined as those gains recognized within five years of the ownership change subject to an overall limitation of the net unrealized built-in gains existing as of the ownership change date. We believe we have net unrealized built-in gains sufficient to allow utilization of the entire net operating loss, assuming that we are able to recognize these gains within the five-year time limitation. We estimate that as of July 31, 2006, we have experienced a three-year cumulative ownership shift of approximately 44%, as computed in accordance with Section 382.

Homebuilding Revenues and Cost of Sales

Our homebuilding operation generates revenues from the sale of homes to homebuyers. The majority of these homes are designed to appeal to move-up homebuyers and the homes are generally offered for sale in advance of their construction. Sales contracts are usually subject to certain contingencies such as the buyer s ability to qualify for financing. Revenue from the sale of homes is recognized at closing when title passes to the buyer, and the earnings process is complete. As a result, our revenue recognition process does not involve significant judgments or estimates. However, we do rely on certain projections and estimates to determine the related construction costs and resulting gross margins associated with revenues recognized. The cost of sales is recorded based upon total estimated costs within a subdivision and allocated using the relative sales value method. Our construction costs are comprised of direct and allocated costs, including estimated costs for future warranties and indemnities. Our estimates are based on historical results, adjusted for current factors.

Litigation Reserves

We and certain of our subsidiaries have been named as defendants in various cases arising in the normal course of business and regarding assets and businesses disposed of by us or our former affiliates. See Notes 5 and 7 to the Consolidated Financial Statements. We have reserved for costs expected to be incurred with respect to these cases based upon information provided by our legal counsel. There can be no assurance that total litigation costs actually incurred will not exceed the amount of such reserve.

Recent Accounting Pronouncements

See discussion regarding recent accounting pronouncements in Note 2 to the Consolidated Financial Statements.

Results of Operations

Three Months Ended June 30, 2006 Compared with the Three Months Ended June 30, 2005

We reported revenues of $18.8 million and gross operating profit of $3.2 million for the second quarter of 2006, compared with $3.1 million in revenues and gross operating profit of $900,000 for the same period of 2005. Revenues in the current period reflect deliveries of 28 homes, including 16 homes at the Alisal project in Lancaster, six homes at the Chandler Ranch project in North Corona and six homes at the Rancho Santa Fe project. The comparable period of the prior year reflects deliveries of four homes at the Jasper Ranch project in Riverside. The current quarter s gross margin of 17.0% is lower than the prior period gross margin of 29.0% due to the lower profitability of the Lancaster and North Corona (Chandler Ranch) homes delivered during the current quarter as compared with the Riverside (Jasper Ranch) homes delivered during the comparable period of the prior year. Revenue per home declined by $104,000, reflecting the lower price level of homes in Lancaster compared with homes in the Inland Empire and a higher-end product delivered at our Jasper Ranch project in 2005. The decline in gross margin percentage reflects lower levels of price appreciation resulting from shorter holding periods for the land underlying the homes delivered during the three months ended June 30, 2006.

The $700,000 increase in selling, general and administrative expenses during the second quarter of 2006, as compared with the second quarter of 2005, primarily reflects an increased accrual for incentive-formula bonuses related to the increased profitability of our homebuilding business.

The $300,000 increase in other income during the second quarter of 2006 compared with the second quarter of 2005 primarily reflects interest income on short-term investments during the 2006 period.

Six Months Ended June 30, 2006 Compared with Six Months Ended June 30, 2005

We reported revenues of $46.7 million and gross operating profit of $7.9 million for the first six months of 2006 compared with $9.6 million in revenues and gross operating profit of $2.6 million for the first six months of 2005. Our revenues during the current six-month period were significantly higher than the prior six-month period due to the greater number of homes delivered, while the average revenue per home decreased by $79,000 to $607,000. Revenues in the first six months of 2006 reflect deliveries of 77 homes, including 44 homes at our North Corona project, 26 homes at the Lancaster project, six homes at our Rancho Santa Fe project, and one home at the Riverside (Jasper Ranch) project. The comparable period of the prior year reflects an aggregate of 14 homes including 10 homes at the Chino project and four homes at the Jasper Ranch project. The decrease in revenue per home reflects the lower price level of homes in Lancaster compared with homes in the Inland Empire and a higher-end product delivered at our Jasper Ranch project in 2005. The homebuilding gross margin for the first six months of 2006 of 16.9% is lower than the prior period gross margin of 27.1% and the per unit average gross margin decreased by $83,000 to $103,000. The decline in gross margin percentage reflects lower levels of price appreciation resulting from shorter holding periods for the land underlying the homes delivered during the six months ended June 30, 2006.

The $1.2 million increase in selling, general and administrative expenses during the first six months of 2006 compared with the first six months of 2005 primarily reflects an increased accrual for incentive-formula bonuses related to the increased profitability of our homebuilding businesses.

The $800,000 increase in other income during the six months ended June 30, 2006 as compared with the same period last year primarily reflects interest income on short-term investments during the 2006 period.

During the quarter ended March 31, 2005, we recorded reversals of valuation allowances on post-Reorganization NOLs of $4.7 million following the Coastal Commission s approval of the development plan for 349 homes on the Upper Mesa (see Note 6), which is reflected in Results of Operations for the six months ended June 30, 2005.

Payments Under Contractual Obligations

We have entered into certain contractual obligations to make future payments for items such as project debt, lease agreements and liability insurance. A summary of the payments due under specified contractual obligations, aggregated by category of contractual obligation, for specified time periods is presented below as of June 30, 2006 (in millions):

		Payments due by period			
	Total	**Less than 1 year**	**1-3 years**	**4-5 years**	**More than 5 years**
Project debt	$ 48.7	$ 48.7	$	$	$
Operating leases	.1	.1			
Insurance premium payable	4.3	4.3			
Total	$ 53.1	$ 53.1	$	$	$

Our purchase contracts which are made in the normal course of our homebuilding business for land acquisition and construction subcontracts are generally cancelable at will. Other contractual obligations including our tax liabilities, accrued benefit liability for a frozen retirement plan and other accrued pensions, home warranty reserves and contingent indemnity and environmental obligations are estimated based on various factors. Payments are not due as of a given date, but rather are dependent upon the incurrence of professional services, the lives of annuitants and other factors. The estimation process involved in the determination of carrying values of these obligations is inherently uncertain since it requires estimates as to future events and contingencies. We have provided additional disclosure in Item 1. Legal Proceedings and in Note 5 to our Consolidated Financial Statements.

Liquidity and Capital Resources

Year-over-year changes in the principal components of our liquidity and capital resources are as follows (in millions, except percentages):

	Six Months Ended June 30, 2006	2005
Cash and cash equivalents	$ 2.7	$ 5.4
Short-term investments	15.1	
Cash used in operating activities	9.3	55.3
Cash provided by investing activities	13.6	.5
Cash (used in) provided by financing activities	(9.3)	51.2

The principal assets in our portfolio are residential land which must be held over an extended period of time in order to be developed to a condition that, in management s opinion, will ultimately maximize our return. Consequently, we require significant capital to finance our real estate development and homebuilding operations. Historically, sources of capital have included loan facilities secured by specific projects, asset sales and available internal funds. We are currently utilizing internally generated cash to fund our Brightwater development at Bolsa Chica and, along with joint venture contributions, to fund the Oxnard land development project. We expect to obtain construction financing for infrastructure and homebuilding activities at Brightwater during the third quarter of 2006 as further described in Note 8 to the Financial Statements. We expect to make aggregate additional capital contributions of approximately $700,000 to the Oxnard joint venture during the next 15 months, bringing our total expected investment in the project to $1.8 million. For the year to date period, we have primarily utilized internally generated cash to fund new construction at our homebuilding projects in order to reduce the negative arbitrage between interest costs on project debt compared with interest income earned on short-term investments. As of June 30, 2006, based on construction in place, the immediately available borrowing capacity on our construction loan facilities is approximately $20 million, and additional facility availability for future construction costs is approximately $55 million. Our current and pending homebuilding projects (excluding Brightwater), which are primarily in the Inland Empire area of Southern California (Riverside and San Bernardino counties) and Lancaster in northeastern Los Angeles County, are currently expected to generate approximately $95 million of positive cash flows over the next three years, based on present economic conditions and market assumptions. However, any adverse change in such conditions or assumptions would adversely impact the amount of our cash flows. Our unrestricted cash and cash equivalents and short-term investments as of June 30, 2006 were $17.8 million. We believe that our cash and cash equivalents, short-term investments, future real estate sales proceeds, and funds available under our current and future credit agreements will be sufficient to meet anticipated operating and capital investment requirements, including payment of the special dividend discussed in Strategic Alternatives above and in Note 8 to the Financial Statements and project development costs for homebuilding projects, the Oxnard and Brightwater land development projects, and general and administrative expenses, for at least the next 12 months.

We are subject to the usual obligations associated with entering into contracts for the purchase of land and improved homesites. The purchase of properties under these contracts is generally contingent upon satisfaction of certain requirements by the sellers, including obtaining applicable property entitlements. We also utilize option contracts with third-party land sellers and financial entities as a method of acquiring land in staged takedowns and minimizing the use of funds from other corporate financing sources. These option contracts also help to manage the financial and market risk associated with land holdings. Purchase and option contracts generally require the payment of a non-refundable cash deposit of 5% to 15% of the purchase price for the right to acquire lots over a specified period of time (usually one to two years) at predetermined prices. We have the right at our discretion to terminate our obligations under these land purchase and option agreements by forfeiting the cash deposit with no further financial responsibility. As of June 30, 2006, we have one consolidated land option deposit for $25,000 which is refundable. In addition, our unconsolidated Oxnard joint venture has land deposits.

We may enter into land development and homebuilding joint ventures from time to time as a means of expanding our market opportunities, establishing strategic alliances, managing our risk profile and leveraging our capital base. These joint ventures may obtain secured acquisition, development and construction financing, which minimize the use of funds from other corporate financing sources.

June 30, 2006 Compared with December 31, 2005

Cash used in homebuilding operations of $9.3 million for the first half of 2006 primarily reflects real estate sales proceeds of $46.5 million from deliveries of 77 homes, offset by uses of cash for investments in real estate inventories and construction costs of $52.8 million. Additional significant uses of cash include approximately $9.2 million for net repayments of project debt financing to reduce the negative arbitrage between interest costs on project debt and interest income on short-term investments. The primary sources of cash during the period were net sales of short-term investments of $15.2 million. These items, as well as other activity presented in the Statements of Cash Flows, resulted in a $5.0 million decrease in cash and cash equivalents.

The $1.4 million decrease in deferred tax assets primarily reflects the usage of $300,000 of federal Pre-reorganization net operating losses (NOLs) and $1.1 million related to amounts not deductible until paid.

Off Balance Sheet Financing

In the ordinary course of business, we enter into land option contracts in order to procure land for the construction of homes. The use of such option agreements allows us to reduce the risks associated with land ownership and development; reduce our financial commitments, including interest and other carrying costs; and minimize land inventories. Under such land option contracts, we will fund a specified option deposit or earnest money deposit in consideration for the right to purchase land in the future, usually at a predetermined price. Our liability is generally limited to forfeiture of the nonrefundable deposits, letters of credit and other nonrefundable amounts incurred. As of June 30, 2006, we have no consolidated land option deposits and no material third party guarantees.

We also acquire land and conduct residential construction activities through participation in joint ventures in which we hold less than a controlling interest. Through joint ventures, we reduce and share our risk and also reduce the amount invested in land, while increasing our access to potential future home sites. The use of joint ventures also, in some instances, enables us to acquire land which we might not otherwise obtain or access on as favorable terms, without the participation of a strategic partner. While we view the use of unconsolidated joint ventures as beneficial to our homebuilding activities, we do not view them as essential to those activities.

Our investment in unconsolidated joint ventures totaled $1.1 million and $700,000 at June 30, 2006 and December 31, 2005, respectively. These joint ventures had total assets of $7.1 million and $5.8 million as of June 30, 2006 and December 31, 2005, respectively, which included land deposits of $1.8 million and $1.6 million, respectively. In certain instances, we may provide varying levels of guarantees on debt of unconsolidated joint ventures. As of June 30, 2006, we provided no guarantees on debt of unconsolidated joint ventures.

Under the requirements of FASB Interpretation No. 46(R), Consolidation of Variable Interest Entities (FASB Interpretation No. 46(R)), certain of our land option contracts may create a variable interest for us, with the land seller being identified as a VIE. In compliance with FASB Interpretation No. 46(R), we analyze our land option contracts and other contractual arrangements and consider whether we should consolidate the fair value of certain VIEs from which we are purchasing land under option contracts. At June 30, 2006, we had no deposits with VIEs.

ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We utilize project debt financing for acquisition, development and construction of homes. The interest rates on our project debt approximate the current rates available for secured real estate financing with similar terms and maturities, and as a result, their carrying amounts approximate fair value. While changes in interest rates generally do not impact the fair market value of the debt instrument, they do affect our earnings and cash flows. Holding our variable rate debt balance constant as of June 30, 2006, each one point percentage increase in interest rates would result in an increase in variable rate interest incurred for the next 12 months of approximately $487,000.

ITEM 4 - EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

No matter how well a control system is conceived and operated, it can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to costs. Therefore, no cost-effective control systems and no evaluation of controls can provide absolute assurance that all control issues and instances of misstatements due to error or fraud, if any, within our company have been detected.

Evaluation of Disclosure Controls and Procedures

Our chief executive officer and chief financial officer, with the assistance of management, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report (the Evaluation Date). Based on that evaluation, our chief executive officer and chief financial officer concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective to ensure that information required to be disclosed in our reports under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and that such information is accumulated and communicated to management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls

There have been no significant changes in our internal control over financial reporting during the three months ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1 - LEGAL PROCEEDINGS

See Note 7 to the Consolidated Financial Statements above, and Item 1 - Business - Corporate Indemnification Matters and Item 3 - Legal Proceedings in our Annual Report on Form 10-K for the year ended December 31, 2005.

ITEM 1A - RISK FACTORS THAT MAY AFFECT RESULTS OF OPERATIONS AND FINANCIAL CONDITION

There has not been any material change in the risk factors disclosure from that contained in our Form 10-K for the fiscal year ended December 31, 2005; however, the risks and uncertainties described in the Form 10-K are not the only ones facing us. Other events that we do not currently anticipate or that we currently deem immaterial also may affect our results of operations and financial condition.

ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Our Annual Meeting of stockholders was held on June 27, 2006. A quorum of common stock was present in person or by proxy. The following proposals were approved by the requisite vote of our stockholders entitled to vote, as follows:

Proposal No. 1: ***The Director Proposal.*** The director proposal recommended election of four directors to a one-year term. Set forth below is a table of how the votes were cast for each nominee, which constituted the affirmative votes for all nominees, by the holders of at least 81.9% of the outstanding common stock represented in person or by proxy at the Annual Meeting.

Name	Votes Cast For Nominee	Votes Withheld
Geoffrey W. Arens	7,470,225	1,615,881
Phillip R. Burnaman II	7,470,225	1,615,881
Raymond J. Pacini	7,500,819	1,585,287
Thomas W. Sabin, Jr.	7,440,934	1,645,172

Proposal No. 2: ***The Stock Option/Stock Issuance Plan Amendment Proposal.*** The holders of common stock cast 6,143,933 votes for and 1,418,773 votes against the proposal to increase the number of shares of common stock issuable under the Amended and Restated 1993 Stock Option Stock Issuance Plan by an additional 250,000 shares, and to extend its term to December 31, 2020. Such votes constituted the affirmative vote for the Stock Option/Stock Issuance Plan Amendment Proposal by the holders of approximately 60.5% of the outstanding common stock. There were 190,524 abstentions and 1,332,876 broker non-votes by the holders of shares of common stock with respect to the Stock Option/Stock Issuance Plan Amendment Proposal.

Proposal No. 3: ***The Auditor Proposal.*** The holders of common stock cast 8,887,447 votes for and 12,659 votes against the proposal to ratify the appointment of Deloitte & Touche, LLP as our independent registered public accounting firm for the fiscal year ending December 31, 2006. Such votes constituted the affirmative vote for the Auditor Proposal by the holders of approximately 97.8% of the outstanding common stock represented in person or by proxy at the Annual Meeting. There were 186,000 abstentions and no broker non-votes by the holders of shares of common stock with respect to the Auditor Proposal.

ITEM 6 - EXHIBITS

10.1 Amended and Restated 1993 Stock Option/Stock Issuance Plan.

10.2 Retirement Plan of the Registrant, Amended and Restated through December 19, 2001, dated December 21, 2001.

10.3 Amendment No. 1 to Retirement Plan of the Registrant dated December 30, 2002.

31.1 Section 302 Certificate of Raymond J. Pacini, Chief Executive Officer of California Coastal Communities, Inc.

31.2 Section 302 Certificate of Sandra G. Sciutto, Chief Financial Officer of California Coastal Communities, Inc.

32 Section 906 Certificate of Raymond J. Pacini, Chief Executive Officer and Sandra G. Sciutto, Chief Financial Officer of California Coastal Communities, Inc.*

* These certifications are being furnished solely to accompany this report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and are not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 8, 2006	CALIFORNIA COASTAL COMMUNITIES, INC.	
	By:	*/s/ Sandra G. Sciutto* SANDRA G. SCIUTTO Senior Vice President and Chief Financial Officer

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