

# CHAIRMAN'S MESSAGE TO SHAREHOLDERS

Great companies are often defined by their deft navigation through challenging times when depth of strength is put to the ultimate test. Over the past four years, Nortel's steadfast determination has driven the Company forward through a dramatic industry downturn and financial restatements to arrive at a position of hard-earned optimism for the future.

With 2005 revenues for Nortel reaching a four-year high of \$10.5 billion and overall growth of the Company's business expected to continue in 2006, Nortel has established a solid foundation to continue its transformation and renewal.

To ensure these efforts are untethered from past restrictions, we have arranged new debt financing and are finalizing our settlement of certain class action suits related to accounting and other financial issues dating back to 2000. The lifting of these restrictions will free Nortel from limitations that had inhibited our access to capital markets.

## Executive and Board Renewal

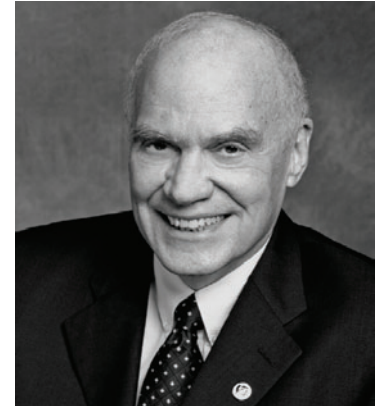
When I was named as the new Chairman of Nortel's Board of Directors in June 2005, the Company was emerging from an arduous 18-month financial restatement process, representing one of the most difficult periods in its 110-year history. Renewal of both executive leadership and the Board were established as immediate vital priorities. The unwavering commitment of Nortel's employees, loyal customers and dedicated shareholders deserved nothing less.

Through a global executive recruitment effort undertaken by the Board's four-member search committee, we selected Mike Zafirovski to succeed Bill Owens as Nortel's president and CEO in November 2005. A 30-year industry veteran with impressive experience at two of the world's highest profile corporate innovators - General Electric and Motorola - Mike was identified as the right leader to take Nortel to the next level by building on the important results Bill had achieved.

At a time of enormous need, the Board turned to Bill - one of its own members - to provide the experienced, steady leadership required to re-establish stability within Nortel and credibility externally with stakeholders. Bill delivered, skillfully guiding the Company through its financial difficulties while maintaining the loyalty of our customers which is fundamental to our future.

Picking up the torch from Bill, Mike has moved quickly and decisively to clearly define aggressive yet attainable objectives

for confronting Nortel's shortcomings and expanding on its strengths. In his Message to Shareholders on page iv, Mike defines the scope of his multi-faceted plan to increase shareholder value in Nortel through strategic initiatives designed to power momentum for continuous and measurable improvement.



**Harry J. Pearce**  
Chairman of the Board

Over the past several months, the Board has worked to enhance the considerable talent of the Company's existing leadership to maximize its support of Mike's objectives. We have hired, and will continue to hire, new executive talent to broaden our global business expertise in key functions such as operations, global manufacturing, supply chain and quality, technology, human resources, marketing, finance and legal.

Renewal of the Board is well underway and by its nature is an open-ended and continuing process. As current directors retire, we are taking the opportunity to enhance the skills available to the Board. At our annual meeting last June, four new members were elected -- the Hon. James B. Hunt, Jr. of Raleigh, North Carolina, Jalynn Bennett, John MacNaughton and Ronald Osborne, all of Toronto, Ontario. We are pleased to include for nomination as directors at our upcoming 2006 annual meeting Claude Mongeau of Montreal, Quebec and John Watson of Calgary, Alberta.

These new directors, and two other nominees to be named shortly, bring a wide range of experience to the Board in finance, strategic planning, organizational structure, leadership excellence and the telecommunications industry. Their combined expertise ensures a smooth transition as four directors of immense talent retire from their exemplary service to the Board at the 2006 meeting - John Brown, John Cleghorn, Robert Ingram and Ronald Osborne.

The diligence and dedication of these four outgoing directors cannot be over emphasized. Through hundreds of hours and countless late nights, they worked tirelessly behind the scenes to ensure Nortel not only persevered through difficulty but emerged better for it with a decisive agenda for achieving financial transformation and transparent accounting practices.

## Finance Transformation

As part of our ongoing remediation, we undertook intensive efforts in 2005 to enhance our controls and procedures relating to revenue recognition. These efforts involved an extensive customer contract review and a review of our revenue recognition policies and discussions with our independent auditors as part of the 2005 audit. As a result, we determined that we had misinterpreted certain of these policies, which resulted in the need to restate financial results for 2003, 2004 and the first nine months of 2005 with adjustments to periods prior to 2003. This was primarily due to revenue incorrectly recognized in prior periods that should have been deferred to future periods.

Though unfortunate, the restatement reflects our long-term commitment to ensuring the Company has a firm foundation going forward with respect to its financial controls and processes.

A critical element of the broader Finance Transformation focuses on financial accountability. To streamline our financial processes for both efficiency and cost-effectiveness, Nortel is in the process of implementing global standard processes based on SAP business solutions software. The staged implementation of this automated system will dramatically enhance real-time, consistent and reliable information within and across businesses, regions and specialist functions.

The Finance Transformation objectives foster leading practices for transparent reporting and re-establishing a strong control environment that is of the highest quality and integrates financial and business processes to add value to the Company.

## Governance

Excellence in corporate governance is the essential foundation for good corporate results that build value for shareholders. This foundation is complex by necessity and includes elements designed to ensure persistent vigilance. Through good governance, the Board must ensure the path of profitability is governed by the highest of ethical standards, accountability, sound management, and business strategies that balance acceptable risk with the aggressive pursuit of excellent returns.

Nortel is strongly committed to effective corporate governance and compliance with U.S. Sarbanes-Oxley standards as well as U.S. and Canadian securities laws. And, our efforts in striving for the highest levels of corporate governance do not stop there. The Board suggests governance reforms through an ongoing process to ensure Nortel adopts and maintains the most effective corporate governance policies and practices.

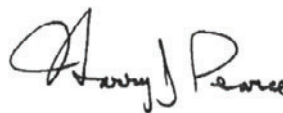
Our code of business conduct and ethics – *Living the Values: A Guide to Ethical Business Practices at Nortel* – applies to all our directors, officers and employees. Every employee is required to read it and respond to our Ethics Recertification process on an annual basis.

The code provides detailed parameters and guidelines on Nortel's approach to competition in the marketplace, the personal standards of conduct expected, and sets out the central role integrity must play in daily conduct with particular emphasis on honesty, compliance with all applicable laws and a commitment to involvement in the communities where Nortel operates.

While the Board provides oversight of Nortel's leadership and business, our governance guidelines also require annual evaluation of the effectiveness of our boards, committees and individual directors. The Board's Nominating and Governance Committee, consisting of five independent directors, reviews, approves and makes recommendations on all corporate governance matters including assessment of the effectiveness of the Board itself.

Throughout 2006, Nortel will continue to drive business forward with a renewed focus on execution and operational and governance excellence through the simplification of our businesses and processes in keeping with our new theme – *Business Made Simple*. We remain committed to our business strategy of technology and solutions evolution that helps our customers transform their networks and implement new applications and services to drive improved productivity, reduced costs and revenue growth. And within all we strive to achieve, shareholder trust will never be taken for granted.

Over the years I have had the privilege to work for many fine organizations, and I now count Nortel among them. I look forward with great enthusiasm to the opportunities ahead in continuing to chart a course of renewal and transformation for Nortel. This is a great Canadian company and although we have made significant progress in 2005 we are ever aware of how much there is yet to do.



Harry J. Pearce  
Chairman of the Board