SWIDLER BERLIN SHEREFF FRIEDMAN, LLP

WASHINGTON OFFICE
3000 K STREET, NW, SUITE 300
WASHINGTON, DC 20007-5116
TELEPHONE (202) 424-7500
FACSIMILE (202) 424-7647

DEPOSIT DATE
D023 OCT 21 1998

NEW YORK OFFICE
919 THIRD AVENUE
NEW YORK, NY 10022-9998
TELEPHONE (212) 758-9500
FACSIMILE (212) 758-9526

October 20, 1998

VIA OVERNIGHT DELIVERY

981377-TI

Mr. Walter D' Haeseleer
Florida Public Service Commission
Division of Communications
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Re: International Exchange Communications, Inc. d/b/a IE Com's Application for Authority to Provide Interexchange Telecommunications Service.

Dear D'Haeseleer:

On behalf of International Exchange Communications, Inc. d/b/a IE Com ("IE Com"), enclosed for filing are an original and six (6) copies of IE Com's Application for Authority to provide Interexchange Telecommunications Service within the State of Florida.
Also enclosed is a check in the amount of $250.00 to cover the application filing fee.

Please date-stamp the enclosed extra copy of this filing and return it in the self-addressed, postage-paid envelope provided. Should you have questions regarding this filing, please do not hesitate to contact us.

Check received with filing and forwarded to Fiscal for deposit. Fiscal to forward a copy of check to RAR with proof of deposit.
Initials of person who forwarded check: A.S.

Very truly yours,

Maria L. Cattafesta

Catherine Wang
Maria L. Cattafesta

Counsel for International Exchange Communications, Inc. d/b/a IE Com

Enclosures

cc: Charles G. Taylor, Jr.

RECEIVED
98 OCT 21 PM 12:30
MAIL ROOM

DOCUMENT NUMBER-DATE
11734 OCT 21 98
FPSC-RECORDS/REPORTING

BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

International Exchange Communications, Inc. d/b/a IE Com Request for Authority to Provide Interexchange Telecommunications Service within the State of Florida	)	Docket No. 981377-TI

APPLICATION FORM
for
AUTHORITY TO PROVIDE INTEREXCHANGE TELECOMMUNICATIONS SERVICE WITHIN THE STATE OF FLORIDA

DOCUMENT NUMBER-DATE
11734 OCT 21 98
FPSC-RECORDS/REPORTING

5. National address (including street name and number, post office box, city, state, and zip code):

International Exchange Communications, Inc.
533 Airport Boulevard, Suite 505
Burlingame, CA 940101
Telephone: (650) 375-6700
Facsimile: (650) 375-6799

6. Florida address (including street name and number, post office box, city, state, and zip code):

Applicant does not have an office in the State of Florida. The Florida registered agent is listed on page 4, item 9 (b) of this application.

7. Structure of organization:

( ) Individual
(X) Foreign Corporation
( ) General Partnership
( ) Other, ____________________
( ) Corporation
( ) Foreign Partnership
( ) Limited Partnership

8. If applicant is an individual or partnership, please give name, title, and address of sole proprietor or partners.

Not applicable.

(a) Provide proof of compliance with the foreign limited partnership statute (Chapter 620.169 FS), if applicable.

(b) Indicate if the individual or any of the partners have previously been:

(1) adjudged bankrupt, mentally incompetent, or found guilty of any felony or of any crime, or whether such actions may result from pending proceedings.

(2) officer, director, partner, or stockholder in any other Florida certificated telephone company. If yes, give name of company and relationship. If no longer associated with company, give reason why not.

9. If incorporated, please give:

(a) Proof from the Florida Secretary of State that the applicant has authority to operate in Florida.

Applicant's Certificate of Authority to Transact Business in Florida is attached as Exhibit 1.

Corporation charter number: **F98000002337**

(b) Name and address of the company's Florida registered agent.

HIQ Corporate Services, Inc.
529 East Park Avenue
Tallahasse, FL 32301

(c) Provide proof of compliance with the fictitious name statute (Chapter 865.09 FS), if applicable.

Please See Exhibit 2

Fictitious name registration number: **G98147900013**

(d) Indicate if any of the officers, directors, or any of the ten largest stockholders have previously been:

(1) adjudged bankrupt, mentally incompetent, or found guilty of any felony or of any crime, or whether such actions may result from pending proceedings.

No.

(2) officer, director, partner, or stockholder in any other Florida certificated telephone company. If yes, give name of company and relationship. If no longer associated with company, give reason why not.

No.

(d) Complaints/Inquiries from customers:

IE Com maintains a toll free number, 1-888-551-0597, through which IE Com customers can reach IE Com's Customer Service Department 24 hours a day, seven days a week for assistance with all products or billing inquiries, changes or additions to their accounts and trouble reports or service complaints.

11. List the states in which the applicant:

(a) Has operated as an interexchange carrier.

California, Connecticut, Maryland, Massachusetts, Michigan, New Jersey, New York and Texas.

(b) Has applications pending to be certificated as an interexchange carrier.

Georgia, Illinois and Pennsylvania.

(c) Is certificated to operate as an interexchange carrier.

California, Connecticut, Maryland, Massachusetts, Michigan, New Jersey, New York and Texas.

(d) Has been denied authority to operate as an interexchange carrier and the circumstances involved.

None.

(e) Has had regulatory penalties imposed for violations of telecommunications statutes and the circumstances involved.

None.

(f) Has been involved in civil court proceedings with an interexchange carrier, local exchange company, or other telecommunications entity and the circumstances involved.

None.

12. What services will the applicant offer to other certificated telephone companies:

( ) Facilities
( ) Billing and Collection
( ) Maintenance
(X) Other: Resold interexchange services
( ) Operators
( ) Sales

13. Do you have a marketing program?

IE Com has not yet adopted a marketing strategy for Florida, thus it does not have a finalized marketing program. However, only employees of IE Com will be marketing or selling IE Com's services.

14. Will your marketing program:

( ) Pay commissions?
( ) Offer sales franchises?
( ) Offer multi-level sales incentives?
( ) Offer other sal s incentives?

15. Explain any of the offers checked in question 14 (to whom, what amount, type of franchise, etc.).

Not applicable.

16. Who will receive the bills for your services (check all that apply)?

(X) Residential Customers
( ) PATS Providers
( ) Hotels and Motels
( ) Universities
( ) Other, ______
(X) Business Customers
( ) PATS Station End-Users
( ) Hotel and Motel Guests
( ) Univ. Dormitory Residents

17. Please provide the following (if applicable):

(a) Will the name of your company appear on the bill for your services and, if not, who will the billed party contact to ask questions about the bill (provide name and phone number) and how is this information provided?

IE Com's company name will appear on customer bills. Customers may call IE Com's toll-free number, 1-888-551-0597, for customer service inquires.

(b) Name and address of the firm who will bill for your services.

IE Com customers in Florida will be billed by Operator Assistance Network ("OAN") in conjunction with the billing and collection contracts with the customer's local exchange company, primarily Bell South.

OAN's address is: OAN Services, Inc.
9255 Corbin Street
Northridge, CA 91324

18. Please provide all available documentation demonstrating that the applicant has the following capabilities to provide interexchange telecommunications service in Florida.

A. Financial capability.

Regarding the showing of financial capability, the following applies:

The application should contain the applicant's financial statements, including:

1. the balance sheet

2. income statement

3. statement of retained earnings for the most recent 3 years.

If available, the financial statements should be audited financial statements.

If the applicant does not have audited financial statements, it shall be so stated. The unaudited financial statements should then be signed by the applicant's chief executive officer and chief financial officer. The signatures should affirm that the financial statements are true and correct.

IE Com intends to rely on the financial resources of its parent Pacific Gateway Exchange, Inc. ("PGE"). PGE's SEC Form 10-K for the year ended December 31, 1998 and its SEC Form 10-Q for the quarter ended June 30, 1998 is attached as **Exhibit 3.**

B. Managerial capability.

Please see Exhibit 4.

C. Technical capability.

Please see Exhibit 4.

19. Please submit the proposed tariff under which the company plans to begin operation. Use the format required by Commission Rule 25-24.485 (example enclosed).

    Please see Exhibit 5.

20. The applicant will provide the following interexchange carrier services (check all that apply):

    ( ) MTS with distance sensitive per minute rates

    - ( ) Method of access is FGA
    - ( ) Method of access is FGB
    - ( ) Method of access is FGD
    - ( ) Method of access is 800

    ( ) MTS with route specific rates per minute

    - ( ) Method of access is FGA
    - ( ) Method of access is FGB
    - ( ) Method of access is FGD
    - ( ) Method of access is 800

    (X) MTS with statewide flat rates per minute (*i.e.*, not distance sensitive)

    - ( ) Method of access is FGA
    - ( ) Method of access is FGB
    - (X) Method of access is FGD
    - (X) Method of access is 800

    ( ) MTS for pay telephone service providers

    ( ) Block-of-time calling plan (Reach Out Florida, Ring America, etc.)

    (X) 800 Service (toll free)

    ( ) WATS-type Service (bulk or volume discount)

    - ( ) Method of access is via dedicated facilities
    - ( ) Method of access is via switched facilities

    ( ) Private Line Services (channel services) (*i.e.*, 1.544 mbs., DS-3, etc.)

(X) Travel Service

- ( ) Method of access is 950
- (X) Method of access is 800

( ) 900 Service

( ) Operator Services

- ( ) Available to presubscribed customers
- ( ) Available to non-presubscribed customers (*i.e.*, to patrons of hotels, students in universities, patients in hospitals)
- ( ) Available to inmates

Services included are:

- ( ) Station assistance
- ( ) Person-to-Person assistance
- ( ) Directory assistance
- ( ) Operator verify and interrupt
- ( ) Conference calling

21. What does the end-user dial for each of the interexchange carrier services that were checked in services included (above)?

The end user dials 1+ or 1010597.

22. Other:

Applicant hereby requests a waiver from Rule 25-4.017, F.A.C., requiring use of the Uniform System of Accounts for Telecommunications Companies ("USOA"). Applicant request permission to utilize Generally Accepted Accounting Principles ("GAAP").

** APPLICANT ACKNOWLEDGMENT STATEMENT **

1. **REGULATORY ASSESSMENT FEE:** I understand that all telephone companies must pay a regulatory assessment fee in the amount of .15 of one percent of its gross operating revenue derived from intrastate business. Regardless of the gross operating revenue of a company, a minimum annual assessment fee of $50 is required.

2. **GROSS RECEIPTS TAX:** I understand that all telephone companies must pay a gross receipts tax of two and one-half percent on all intra and interstate business.

3. **SALES TAX:** I understand that a seven percent sales tax must be paid on intra and interstate revenues.

4. **APPLICATION FEE:** A non-refundable application fee of $250.00 must be submitted with the application.

5. **RECEIPT AND UNDERSTANDING OF RULES:** I acknowledge receipt and understanding of the Florida Public Service Commission's Rules and Orders relating to my provision of interexchange telephone service in Florida. I also understand that it is my responsibility to comply with all current and future Commission requirements regarding interexchange telephone service.

6. **ACCURACY OF APPLICATION:** By my signature below, I, the undersigned owner or officer of the named utility in the application, attest to the accuracy of the information contained in this application and associated attachments. I have read the foregoing and declare that, to the best of my knowledge and belief, the information is a true and correct statement.

   Further, I am aware that, pursuant to Chapter 837.06, Florida Statutes, "Whoever knowingly makes a false statement in writing with the intent to mislead a public servant in the performance of his official duty shall be guilty of a misdemeanor of the second degree, punishable as provided in s. 775.082 and s. 775-083."

UTILITY OFFICIAL:

Charles G. Taylor, Jr. — 10/2/98

Signature — Date

Charles G. Taylor, Jr.

Name

SVP - Int'l Mkt Dev

Title

International Exchange Communications, Inc. d/b/a IE Com
Telephone: (650) 375-6700
Facsimile: (650) 375-6799

FORM PSC/CMU 31 (3/96)
Required by Commission Rule Nos. 25-24.471 and 25-24.473.

**** APPENDIX A ****

CERTIFICATE TRANSFER STATEMENT

Not Applicable, IE Com is applying for original authority.

I, (TYPE NAME) ________________________________, **(TITLE)** ______

____________________, of **(NAME OF COMPANY)**

________________________________, and current holder of certificate

number ______________, have reviewed this application and join in the petitioner's

request for a transfer of the above-mentioned certificate.

UTILITY OFFICIAL:

	________________________ Signature	____________________ Date
	________________________	
	________________________ Title	____________________ Telephone Number

FORM PSC/CMU 31 (3/96)
Required by Commission Rule Nos. 25-24.471 and 25-24.473.

**** APPENDIX B ****

CUSTOMER DEPOSITS AND ADVANCE PAYMENTS

A statement of how the Commission can be assured of the security of the customer's deposits and advance payments may be responded to in one of the following ways (applicant, please check one):

(X) The applicant will not collect deposits nor will it collect payments for service more than one month in advance.

( ) The applicant will file with the Commission and maintain a surety bond in an amount equal to the current balance of deposits and advance payments in excess of one month. (Bond must accompany application.)

IE Com does not require customer deposits.

UTILITY OFFICIAL:

Charles G. Taylor, Jr. — Signature — 10/2/98 — Date

CHARLES G. TAYLOR, JR — Name

SVP-INT'L MKT DEV — Title

International Exchange Communications, Inc. d/b/a IE Com
Telephone: (650) 375-6700
Facsimile: (650) 375-6799

FORM PSC/CMU 31 (3/96)
Required by Commission Rule Nos. 25-24.471 and 25-24.473.

** APPENDIX C **

INTRASTATE NETWORK
Not Applicable

1. **POP:** Addresses where located, and indicate if owned or leased.

   1) 2)

   3) 4)

2. **SWITCHES:** Addresses where located, by type of switch, and indicate if owned or leased.

   1) 2)

   3) 4)

3. **TRANSMISSION FACILITIES:** POP-to-POP facilities by type of facilities (microwave, fiber, copper, satellite, etc.) and indicate if owned or leased.

POP-to-POP	TYPE	OWNERSHIP
1)		
2)		

4. **ORIGINATING SERVICE:** Please provide the list of exchanges where you are proposing to provide originating service within thirty (30) days after the effective date of the certificate (Appendix D).

**** APPENDIX C ****

INTRASTATE NETWORK (continued)

5. **TRAFFIC RESTRICTIONS:** Please explain how the applicant will comply with the EAEA requirements contained in Commission Rule 25-24.471(4)(a) (copy enclosed).

   IE Com initially proposes to provide interexchange service on a resale basis. The certificated carriers from which IE Com will purchase services for resale will be responsible for complying with Commission Rule 25-24.471(4)(a).

6. **CURRENT FLORIDA INTRASTATE SERVICES:** Applicant has ( ) or has not (X) previously provided intrastate telecommunications in Florida. If the answer is <u>has</u>, fully describe the following:

   a) What services have been provided and when did these services begin?

   b) If the services are not currently offered, when were they discontinued?

**** APPENDIX C ****

INTRASTATE NETWORK (continued)

UTILITY OFFICIAL:

______________________ ______________________
Signature Date

____
Name

____
Title

International Exchange Communications, Inc. d/b/a IE Com
Telephone: (650) 375-6700
Facsimile: (650) 375-6799

**** APPENDIX D ****

FLORIDA TELEPHONE EXCHANGES AND EAS ROUTES

Describe the service area in which you hold yourself out to provide service by telephone company exchange. If all services listed in your tariff are not offered at all locations, so indicate.

In an effort to assist you, attached is a list of major exchanges in Florida showing the small exchanges with which each has extended area service (EAS).

** FLORIDA EAS FOR MAJOR EXCHANGES **

Extended Service Area	with	These Exchanges
PENSACOLA:		Cantonment, Gulf Breeze Pace, Milton, Holley-Navarre.
PANAMA CITY:		Lynn Haven, Panama City Beach, Youngstown-Fountain and Tyndall AFB.
TALLAHASSEE:		Crawfordville, Havana, Monticello, Panacea, Sopchoppy and St. Marks.
JACKSONVILLE:		Baldwin, Ft. George, Jacksonville Beach, Callahan, Maxville, Middleburg, Orange Park, Ponte Vedra and Julington.
GAINESVILLE:		Alachua, Archer, Brooker, Hawthorne, High Springs, Melrose, Micanopy, Newberry and Waldo.
OCALA:		Belleview, Citra, Dunnellon, Forest Lady Lake (B21), McIntosh, Oklawaha, Orange Springs, Salt Springs and Silver Springs Shores.
DAYTONA BEACH:		New Smyrna Beach.

**** APPENDIX D ****

FLORIDA TELEPHONE EXCHANGES AND EAS ROUTES (continued)

TAMPA:	Central	None
	East	Plant City
	North	Zephyrhills
	South	Palmetto
	West	Clearwater
CLEARWATER:	St. Petersburg, Tampa-West and Tarpon Springs.	
ST. PETERSBURG:	Clearwater.	
LAKELAND:	Bartow, Mulberry, Plant City, Polk City and Winter Haven.	
ORLANDO:	Apopka, East Orange, Lake Buena Vista, Oviedo, Windermere, Winter Garden, Winter Park, Montverde, Reedy Creek and Oviedo-Winter Springs.	
WINTER PARK:	Aopoka, East Orange, Lake Buena Vista, Orlando, Oviedo, Sanford, Windermere, Winter Garden, Oviedo-Winter Springs Reedy Creek, Geneva and Montverde.	
TITUSVILLE:	Cocoa and Cocoa Beach.	
COCOA:	Cocoa Beach, Eau Gallie, Melbourne and Titusville.	
MELBOURNE:	Cocoa, Cocoa Beach, Eau Gallie and Sebastian.	
SARASOTA:	Bradenton, Myakka and Venice.	

**** APPENDIX D ****

FLORIDA TELEPHONE EXCHANGES AND EAS ROUTES (continued)

FT. MYERS:	Cape Coral, Ft. Myers Beach, North Cape Coral, North Ft. Myers, Pine Island, Lehigh Acres and Sanibel-Captiva Islands
NAPLES:	Marco Island and North Naples.
WEST PALM BEACH:	Boyston Beach and Jupiter.
POMPANO BEACH:	Boca Raton, Coral Springs, Deerfield Beach and Ft. Lauderdale
FT. LAUDERDALE:	Coral Springs, Deerfield Beach, Hollywood and Pompano Beach.
HOLLYWOOD:	Ft. Lauderdale and North Dade.
NORTH DADE:	Hollywood, Miami and Perrine.
MIAMI:	Homestead, North Dade and Perrine.

IE Com seeks authority to resell interexchange telecommunications services throughout the State of Florida at the rates identified in its proposed tariff attached hereto as Exhibit 4.

UTILITY OFFICIAL:

Charles G. Taylor, Jr. — 10/2/98
Signature — Date

Charles G. Taylor, Jr.
Name

SVP - Int'l Mkt Dev
Title

International Exchange Communications, Inc. d/b/a IE Com
Telephone: (650) 375-6700
Facsimile: (650) 375-6799

FORM PSC/CMU 31 (3/96)
Required by Commission Rule Nos. 25-24.471 and 25-24.473.

EXHIBITS

EXHIBIT 1	CERTIFICATE OF AUTHORITY TO TRANSACT BUSINESS
EXHIBIT 2	PROOF OF COMPLIANCE WITH FICTITIOUS NAME STATUTE
EXHIBIT 3	FINANCIAL STATEMENTS
EXHIBIT 4	MANAGERIAL AND TECHNICAL QUALIFICATIONS
EXHIBIT 5	PROPOSED TARIFF

EXHIBIT 1

CERTIFICATE OF AUTHORITY TO TRANSACT BUSINESS

FLORIDA DEPARTMENT OF STATE
Sandra B. Mortham
Secretary of State

April 23, 1998

UCC FILING & SEARCH SERVICES

Qualification documents for INTERNATIONAL EXCHANGE COMMUNICATIONS, INC. were filed on April 23, 1998 and assigned document number F98000002337. Please refer to this number whenever corresponding with this office.

Your corporation is now qualified and authorized to transact business in Florida as of the file date.

A corporation annual report will be due this office between January 1 and May 1 of the year following the calendar year of the file date. A Federal Employer Identification (FEI) number will be required before this report can be filed. If you do not already have an FEI number, please apply NOW with the Internal Revenue by calling 1-800-829-3676 and requesting form SS-4.

Please be aware if the corporate address changes, it is the responsibility of the corporation to notify this office.

Should you have any questions regarding this matter, please telephone (850) 487-6091, the Foreign Qualification/Tax Lien Section.

Jennifer Sindt
Document Examiner
Division of Corporations

Letter Number: 098A00022151

Division of Corporations - P.O. BOX 6327 -Tallahassee, Florida 32314

APPLICATION BY FOREIGN CORPORATION FOR AUTHORIZATION TO TRANSACT BUSINESS IN FLORIDA

IN COMPLIANCE WITH SECTION 607.1503, FLORIDA STATUTES, THE FOLLOWING IS SUBMITTED TO REGISTER A FOREIGN CORPORATION TO TRANSACT BUSINESS IN THE STATE OF FLORIDA:

1. INTERNATIONAL EXCHANGE COMMUNICATIONS, INC.

(Name of corporation: must include the word "INCORPORATED", "COMPANY", "CORPORATION" or words or abbreviations of like import in language as will clearly indicate that it is a corporation instead of a natural person or partnership if not so contained in the name at present.)

2. DELAWARE
(State or country under the law of which it is incorporated)

3. 94-3292374
(FEI number, if applicable)

4. 6/27/97
(Date of Incorporation)

5. PERPETUAL
(Duration: Year corp. will cease to exist or "perpetual")

6. UPON ACCEPTANCE
(Date first transacted business in Florida. (SEE SECTIONS 607.1501, 607.1502, AND 817.155, F.S.)

FILED
SECRETARY OF STATE
DIVISION OF CORPORATIONS
98 APR 23 PM 3:44

7. 533 AIRPORT BOULEVARD, SUITE 505
BURLINGAME CA 94010
(Current mailing address)

8. TO CONDUCT RETAIL COMMUNICATIONS SERVICES
(Purpose(s) of corporation authorized in home state or country to be carried out in the state of Florida)

9. **Name and street address of Florida registered agent:** (P.O. Box or Mail Drop Box NOT acceptable)

Name: HIQ CORPORATE SERVICES, INC.

Office Address: 529 EAST PARK AVENUE

TALLAHASSEE, Florida, 32301
(Zip Code)

10. **Registered agent's acceptance:**

Having been named as registered agent and to accept service of process for the above stated corporation at the place designated in this application, I hereby accept the appointment as registered agent and agree to act in this capacity. I further agree to comply with the provisions of all statutes relative to the proper and complete performance of my duties, and I am familiar with and accept the obligations of my position as registered agent.

HIQ CORPORATE SERVICES, INC., BY: ROXANNE D. MONIODIS, SECRETARY

Roxanne D. Moniodis
(Registered agent's signature)

11. Attached is a certificate of existence duly authenticated, not more than 90 days prior to delivery of this application to the Department of State, by the Secretary of State or other official having custody of corporate records in the jurisdiction under the law of which it is incorporated.

STF FL323/9F 3

12. Names and addresses of officers and/or directors: (Street address ONLY- P. O. Box NOT acceptable)

A. DIRECTORS (Street address only- P. O. Box NOT acceptable)

Chairman: SEE ATTACHED

Address:

Vice Chairman:

Address:

Director:

Address:

Director:

Address:

B. OFFICERS (Street address only- P. O. Box NOT acceptable)

President: SEE ATTACHED

Address:

Vice President:

Address:

Secretary:

Address:

Treasurer:

Address:

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SECRETARY OF STATE
DIVISION OF CORPORATIONS
98 APR 23 PM 3:45

NOTE: If necessary, you may attach an addendum to the application listing additional officers and/or directors.

13. Gail Granton

(Signature of Chairman, Vice Chairman, or any officer listed in number 12 of the application)

14. ~~HOWARD NESKOWITZ, PRESIDENT~~ GAIL GRANTON, SECRETARY

(Typed or printed name and capacity of person signing application)

STP FL32376F 4

INTERNATIONAL EXCHANGE COMMUNICATIONS, INC.

LIST OF OFFICERS & DIRECTORS

OFFICERS

Howard Neckowitz, President	**533 Airport Boulevard Burlingame CA 94010**
Gail Granton, VP, Secretary & Treasurer	**533 Airport Boulevard Burlingame CA 94010**

FILED
SECRETARY OF STATE
DIVISION OF CORPORATIONS
98 APR 23 PM 3:44

DIRECTORS

Howard Neckowitz	**533 Airport Boulevard Burlingame CA 94010**
Gail Granton	**533 Airport Boulevard Burlingame CA 94010**

EXHIBIT 2

PROOF OF COMPLIANCE WITH FICTITIOUS NAME STATUTE

FLORIDA DEPARTMENT OF STATE
Sandra B. Mortham
Secretary of State

May 27, 1998

I E COM
533 AIRPORT BLVD., SUITE 505
BURLINGAME, CA 94010

Subject: **I E COM**

REGISTRATION NUMBER: **G98147900013**

This will acknowledge the filing of the above fictitious name registration which was registered on May 27, 1998. This registration gives no rights to ownership of the name.

Each fictitious name registration must be renewed every five years between July 1 and December 31 of the expiration year to maintain registration. Three months prior to the expiration date a statement of renewal will be mailed.

IT IS THE RESPONSIBILITY OF THE BUSINESS TO NOTIFY THIS OFFICE IN WRITING IF THEIR MAILING ADDRESS CHANGES. Whenever corresponding please provide assigned Registration Number.

Should you have any questions regarding this matter you may contact our office at (850) 488-9000.

Reinstatement Section
Division of Corporations

Letter No. 998A00029627

APPLICATION FOR REGISTRATION OF FICTITIOUS NAME

1. ~~IAE/COM~~ I E COM
Fictitious Name to be Registered

2. 533 AIRPORT BLVD, SUITE 505
Mailing Address of Business
BURLINGAME CA 94010
City State Zip Code

3. Florida County of principal place of business: LEON

4. FEI Number: 94-3292374

FILED
98 MAY 27 PM 12:01
SECRETARY OF STATE
TALLAHASSEE, FLORIDA

This space for office use only

A. Owner(s) of Fictitious Name If Individual(s): (Use an attachment if necessary):

1. ____ Last First M.I.
____ Address
____ City State Zip Code
SS# ____-____-____

2. ____ Last First M.I.
____ Address
____ City State Zip Code
SS# ____-____-____

B. Owner(s) of Fictitious Name If other than an individual: (Use attachment if necessary):

1. INTERNATIONAL EXCHANGE COMMUNICATIONS, INC.
Entity Name
533 AIRPORT BLVD, SUITE 505
Address
BURLINGAME CA 94010
City State Zip Code
Florida Registration Number F98000002337
FEI Number: 94-3292374
☐ Applied for ☐ Not Applicable

2. ____ Entity Name
____ Address
____ City State Zip Code
Florida Registration Number ____
FEI Number: ____
☐ Applied for ☐ Not Applicable

I (we) the undersigned, being the sole (all the) party(ies) owning interest in the above fictitious name, certify that the information indicated on this form is true and accurate. I (we) further certify that the fictitious name shown in Section 1 of this form has been advertised at least once in a newspaper as defined in chapter 50, Florida Statutes, in the county where the applicant's principal place of business is located. I (we) understand that the signature(s) below shall have the same legal effect as if made under oath. (At Least One Signature Required)

[signature] 3/2/98
Signature of Owner Date
Phone Number: 650-375-6728

____ Signature of Owner Date
Phone Number: ____

FOR CANCELLATION COMPLETE SECTION 4 ONLY:
FOR FICTITIOUS NAME OR OWNERSHIP CHANGE COMPLETE SECTIONS 1 THROUGH 4:

I (we) the undersigned, hereby cancel the fictitious name ____, which was registered on ____ and was assigned registration number ____

____ Signature of Owner Date
____ Signature of Owner Date

Mark the applicable boxes ☐ Certificate of Status — $10 ☐ Certified Copy — $30

FILING FEE: $50

Note: Acknowledgements/certificates will be sent to the address in Section 1 only.

CR4E-001 (5/96)

EXHIBIT 3

FINANCIAL STATEMENTS

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTER ENDED June 30, 1998

COMMISSION FILE NUMBER 000-21043

PACIFIC GATEWAY EXCHANGE, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware	94-3134065
(State of Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification Number)

533 Airport Blvd, Suite 505, Burlingame, California, 94010

(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code (650) 375 6700

None
(Former Name, Former Address and
Former Fiscal Year if Changed Since Last Report)

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

Yes X No __

As of July 31, 1998, the number of the registrant's Common Shares of $.0001 par value outstanding was 19,144,686

PACIFIC GATEWAY EXCHANGE, INC.

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Item 1. Financial Statements

PACIFIC GATEWAY EXCHANGE, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS
(in thousands)

	(Unaudited) June 30, 1998	December 31, 1997
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 31,265	$ 43,850
Accounts receivable, net of allowance for doubtful accounts of $3,314 in 1998 and $2,230 in 1997	83,109	62,313
Accounts receivable, related party	-	-
Prepaid expenses	872	511
Other current assets	-	1,769
Total current assets	115,246	108,443
Property and equipment, net	71,085	61,433
Investment in companies	5,149	184
Deposits and other assets	2,703	1,557
Total assets	$ 194,183	$ 171,617
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 98,734	$ 87,949
Accrued liabilities	3,974	3,733
Income taxes payable	859	1,491
Other liabilities	2,461	1,871
Total liabilities	106,028	95,044
Commitments and contingencies (Note 6).		
Stockholders' Equity:		
Preferred stock, $.0001 par value, authorized 5,000,000 shares, no shares issued.	-	-
Common stock, $.0001 par value, authorized 70,000,000 shares, issued 19,288,246 shares, outstanding 19,144,686 shares in 1998 and issued 19,216,710 shares, outstanding 19,073,150 shares in 1997	2	2
Additional paid in capital	63,049	60,849
Deferred compensation-restricted stock	(3,927)	(4,134)
Foreign currency translation	60	2
Retained earnings	29,371	20,254
Common stock held in treasury, at cost (143,560 shares in 1998 and 1997)	(400)	(400)
Total stockholders' equity	88,155	76,573
Total liabilities and stockholders' equity	$ 194,183	$ 171,617

See Accompanying Notes to Consolidated Condensed Financial Statements

PACIFIC GATEWAY EXCHANGE, INC.
CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(in thousands, except net income per share)

	Three Months Ended June 30,		Six Months Ended June30,	
	1998	1997	1998	1997
	(Unaudited)			
Revenues	$ 109,952	$ 59,404	$ 215,024	$ 106,928
Revenues - related party	-	3,782	-	7,709
Total revenues	109,952	63,186	215,024	114,637
Cost of long distance services	92,951	51,967	182,192	95,108
Gross margin	17,001	11,219	32,832	19,529
Selling, general and administrative expenses	7,290	5,618	14,852	9,443
Depreciation	2,146	1,267	4,109	2,120
Total operating expenses	9,436	6,885	18,961	11,563
Operating income	7,565	4,334	13,871	7,966
Other (income) expense, net	496	(168)	594	(168)
Interest (income) expense, net	(556)	(327)	(1,169)	(1,015)
Income before income taxes	7,625	5,029	14,446	9,149
Provision for income taxes	2,740	1,987	5,185	3,645
Net income	$ 4,885	$ 3,042	$ 9,261	$ 5,504
Net income per share, basic	$ 0.26	$ 0.16	$ 0.49	$ 0.29
Net income per share, diluted	$ 0.25	$ 0.16	$ 0.46	$ 0.28

See Accompanying Notes to Consolidated Condensed Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(in thousands)

	Six Months Ended June 30,			
	1998		1997	
	(Unaudited)			
Operating Activities:				
Net income	$	9,261	$	5,504
Adjustments to net income:				
Depreciation		4,108		2,055
Stock compensation expense		304		(17)
Bad debts provision		1,204		1,499
Equity in net loss of affiliated companies		152		-
Changes in operating assets and liabilities:				
Accounts receivable		(22,110)		(11,359)
Accounts receivable, related party		-		576
Prepaid expenses		(361)		(56)
Deposits and other assets		953		(868)
Accounts payable		10,807		7,803
Accrued liabilities		241		401
Federal income taxes payable (recoverable)		(554)		(2,247)
Other liabilities		409		243
Net cash used in operating activities		4,414		3,534
Investing Activities:				
Purchase of property and equipment		(13,988)		(22,049)
Purchase of investment		(3,314)		222
Net cash used in investing activities		(17,302)		(21,827)
Financing Activities:				
Exercise of stock options		360		183
Other		(57)		(78)
Net cash provided by financing activities		303		105
Net decrease in cash and cash equivalents		(12,585)		(18,188)
Cash and cash equivalents at beginning of the period		43,850		45,563
Cash and cash equivalents at end of the period	$	31,265	$	27,375
Supplemental data for non-cash investing and financing activities:				
Common stock issued to investee	$	1,800	$	-

See Accompanying Notes to Consolidated Condensed Financial Statements.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(1) GENERAL

The financial statements included herein are unaudited and have been prepared in accordance with generally accepted accounting principles for interim financial reporting and Securities Exchange Commission ("SEC") regulations. 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. In the opinion of management, the financial statements reflect all adjustments (of a normal and recurring nature) that are necessary to present fairly the financial position, results of operations and cash flows for the interim periods. These financial statements should be read in conjunction with the annual report on Form 10-K of Pacific Gateway Exchange, Inc. (the "Company" or "Pacific Gateway") for the year ended December 31, 1997. The results for the three- and six-month periods ended June 30, 1998 are not necessarily indicative of the results that may be expected for future periods.

In accordance with American Institute of Certified Public Accountants Statement of Position 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use", during the first quarter of 1998, the Company began capitalizing costs associated with developing computer software for internal use.

Certain prior-year amounts have been reclassified to conform to the 1998 financial statement presentation.

(2) ACQUISITIONS

On Februay 13, 1998, the Company purchased of 16.6% of Ekonom S.A. de C.V., a Mexican multimedia company existing under the laws of the United Mexican States, for $3,300,000 in cash and $1,800,000 in Pacific Gateway's stock. The Company's investment in Ekonom is accounted for under the cost method.

(3) EARNINGS PER SHARE

(in thousands, except per share amounts)	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Three Months Ended June 30, 1998			
Basic EPS:			
Income available to common stockholders	$ 4,885	19,060	$ 0.26
Effect of stock-based compensation		874	
Diluted EPS	$ 4,885	19,934	$ 0.25
Three Months Ended June 30, 1997			
Basic EPS:			
Income available to common stockholders	$ 3,042	18,938	$ 0.16
Effect of stock-based compensation		622	
Diluted EPS	$ 3,042	19,560	$ 0.16
Six Months Ended June 30, 1998			
Basic EPS:			
Income available to common stockholders	$ 9,261	19,041	$ 0.49
Effect of stock-based compensation		890	
Diluted EPS	$ 9,261	19,931	$ 0.46
Six Months Ended June 30, 1997			
Basic EPS:			
Income available to common stockholders	$ 5,504	18,938	$ 0.29
Effect of stock-based compensation		675	
Diluted EPS	$ 5,504	19,613	$ 0.28

(4) COMPREHENSIVE INCOME

In June 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income". SFAS No. 130 establishes standards for reporting and display of comprehensive income and its components in a financial statement that is displayed with the same prominence as other financial statements. Comprehensive income as defined includes all changes in equity (net assets) during a period from non-owner sources. Examples of items to be included in comprehensive income, which are excluded from net income, include foreign currency translation adjustments. In accordance with the adoption of SFAS No. 130, total other comprehensive income consisted of foreign currency translation totaling approximately $32,000 and $58,000 for the three- and six-month period ending June 30, 1998 respectively.

(5) NEW ACCOUNTING PRONOUNCEMENTS

In June 1997, the FASB issued SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information". This statement establishes standards for the way companies report information about operating segments in annual financial statements. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. The Company is in the process of evaluating the disclosure impact of adopting this new standard. The disclosures prescribed by SFAS No. 131 will be made for the full year financial statements for the year ended December 31, 1998.

In March 1998, the FASB issued SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits". SFAS No. 132 significantly changes current financial statement disclosure requirements from those that were required under SFAS 87. The Company currently does not have a pension or other postretirement benefit plan. Therefore, SFAS No. 132 will not be applicable to the Company.

(6) CONTINGENCIES

The Company currently has operating subsidiaries in foreign locations including U.K., New Zealand and Russia. The Company's operations are subject to certain risks, such as changes in foreign government regulations and telecommunications standards, licensing requirements, tariffs, taxes and other trade barriers, as well as political and economic instability. Subsequent to June 30, 1998, the Company's Russian subsidiary, Rustelnet, was notified by the Russian local tax authorities of a potential local tax liability. The management of Rustelnet has advised the Company that Rustelnet has strong defenses and intends to defend itself vigorously in this matter, since the Company follows policies that are consistent with tax practices utilized in the Russian telecommunications industry. Although no assurances are possible, the Company does not believe that this development will have a material adverse effect on its financial condition or results of operations.

Item 2: Management Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding expected future revenue from delayed proportional return traffic from foreign partners pursuant to certain operating agreements. Forward-looking statements are statements other than historical information or statements of current condition. Some forward-looking statements may be identified by use of terms such as "believes," "anticipates," "plans," "intends" or "expects." These forward-looking statements relate to the plans, objectives and expectations of Pacific Gateway Exchange, Inc. ("Pacific Gateway" or the "Company") regarding its future operations or financial performance or related to the Company's expectations regarding the telecommunications industry. In light of the inherent risks and uncertainties of any forward-looking statement, the inclusion of forward-looking statements in this report should not be regarded as a representation by the Company or any other person that the forward-looking statements will come true. The revenues and results of operations of the Company, and future developments in the telecommunications industry, are difficult to forecast and could differ materially from those projected in the forward-looking statements as a result of numerous factors, including the following: (i) changes in international settlement rates; (ii) changes in the ratios between outgoing and incoming traffic; (iii) foreign currency fluctuations; (iv) termination of certain operating agreements or inability to enter into additional operating agreements; (v) inaccuracies in the Company's forecasts of traffic; (vi) changes in or developments under domestic or foreign laws, regulations, licensing requirements or telecommunications standards; (vii) foreign political or economic instability; (viii) changes in the availability of transmission facilities such as undersea fiber optic cable or in the feasibility of building such facilities; (ix) loss of the services of key officers, such as Howard A. Neckowitz, Chairman of the Board, President and Chief Executive Officer or Gail E. Granton, Executive Vice President, International Business Development and Secretary; (x) loss of a customer which provides significant revenues to the Company; (xi) highly competitive market conditions in the industry; (xii) future management decisions regarding, for example, acquisitions, capital expenditures or financings; (xiii) concentration of credit risk; (xiv) natural disasters and catastrophic events, or (xv) opportunities for (and problems resulting from) the acquisition of other companies or offshore facilities. The foregoing review of important factors, including those discussed in detail below, should not be construed as exhaustive. The Company undertakes no obligation to release publicly the results of any future revisions it may make to forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

The following table sets forth income statement data as a percentage of revenues for the period indicated.

	Three Months Ended June 30,		Six Months Ended June 30,	
	1998	1997	1998	1997
Total Revenues	100.0%	100.0%	100.0%	100.0%
Cost of long distance services	84.5%	82.2%	84.7%	83.0%
Gross margin	15.5%	17.8%	15.3%	17.0%
Selling, general and administrative expenses	6.6%	8.9%	6.9%	8.2%
Depreciation	2.0%	2.0%	1.9%	1.9%
Total operating expenses	8.6%	10.9%	8.8%	10.1%
Operating income	6.9%	6.9%	6.5%	7.0%
Interest (income) expense, net	-0.5%	-0.8%	-0.5%	-0.9%
Other (income) expense, net	0.5%	-0.3%	28.0%	-0.2%
Income before income taxes	6.9%	8.0%	6.7%	8.0%
Provision for income taxes	2.5%	3.1%	2.4%	3.2%
Net income	4.4%	4.8%	4.3%	4.8%

Three Months Ended June 30, 1998 Compared to Three Months Ended June 30, 1997.

Revenues: Total revenues for the three months ended June 30, 1998 increased 74% to $110.0 million from $63.2 million for the three months ended June 30, 1997 and increased 5% from $105.0 million in the quarter ended March 31, 1998. The increase from the quarter ended June 30, 1997 was the result of several factors. First, the Company increased the number of its operating agreements to 43 at June 30, 1998 from 37 at June 30, 1997. Second, the number of wholesale carrier customers increased to 153 at June 30, 1998 from 106 at June 30, 1997. Third, revenues from the Company's retail customers were $4.6 million for the quarter ended June 30, 1998. The Company was not engaged in the retail business for the quarter ended June 30, 1997. As a result of these factors, total minutes increased 70.1% from the three months ended June 30, 1997, while the average price per minute charged to customers improved slightly to $0.29 in the three months ended June 30, 1998, compared to $0.28 in the same quarter last year. Changes in the terminating country mix with significantly different rates per minute, reductions in the rates received for the traffic terminating in and transiting the U.S. and increases in the incidental U.S. domestic terminating traffic influenced the average customer price per minute. During the second quarter of 1998 (as in all prior quarters), the Company sent more minutes out than it received under its operating agreements. Because the same rate is charged by the foreign carrier to terminate calls in their country as the Company charges the foreign carrier to terminate calls in the United States, declining rates have an adverse effect on revenue and estimated return traffic revenue backlog, but, as a result of sending more calls out than the Company receives, declining rates improve the gross margin received on the entire transaction of a minute delivered with such foreign carriers.

Gross Margin: As a percentage of revenue, gross margin was 15.5% in the current three-month period, down from 17.8% in the same period in the prior year. The decrease in margin resulted from higher fixed costs due to offshore start-ups and reconfiguring of the U.S. network. The cost of long distance service increased to $93.0 million in the three months ended June 30, 1998 from $52.0 million in the three months ended June 30, 1997. This increase in costs represents continued growth in outbound traffic on new and existing routes.

Selling, General and Administrative Expenses: Selling, general and administrative expenses as a percentage of revenues were 6.6% in the three months ended June 30, 1998, down from 8.9% in the same period in the prior year. Actual expenses increased 29.8% to $7.3 million in the three months ended June 30, 1998 from $5.6 million in the three months ended June 30, 1997. This increase was due primarily to increased personnel and sales commission expenses. The increase in personnel expenses was directly related to the increase in the number of employees in the Company's wholly owned subsidiaries to 129 at June 30, 1998 from 67 at June 30, 1997. The increase in sales commission expenses was primarily due to increased revenues.

Depreciation: Depreciation increased 69.4% to $2.1 million in the three months ended June 30, 1998 from $1.3 million in the three months ended June 30, 1997. Depreciation as a percentage of revenues was 2.0% of revenue for the three months ended June 30, 1998 and 1997. The increase in the dollar amount was primarily due to depreciation of additional transmission facilities acquired since June 30, 1997.

Income Tax: Income taxes increased to $2.7 million in the three months ended June 30, 1998 from $2.0 million in the three months ended June 30, 1997, primarily due to increased operating income. The effective tax rate was 40.0% in 1997 and 36.0% in 1998. The decrease in effective tax rate was attributable to earnings of certain non-U.S. subsidiaries. A portion of these earnings is intended to be reinvested indefinitely in operations outside the U.S.

Six Months Ended June 30, 1998 Compared to Six Months Ended June 30, 1997.

Revenues: Total revenues for the six months ended June 30, 1998 increased 93% to $215.0 million from $106.9 million in the six months ended June 30, 1997. The increase was primarily the result of increased sales to existing customers, an increase in the number of operating agreements with foreign partners to 43 at June 30, 1998 from 37 at June 30, 1996, and an increase in the number of wholesale customers to 153 at June 30, 1998 from 106 at June 30, 1997. In addition, revenues from the Company's retail customers were $7.7 million for the six months ended June 30, 1998, while there were no retail revenues for the six months ended June 30, 1997.

Gross Margin: As a percentage of revenue, gross margin was 15.3% for the first half of 1998, down from 17.0% for the first half of 1997. The decrease in margin resulted from higher fixed costs due to offshore start-ups and reconfiguring of the U.S. network. The cost of long distance service increased to $182.2 million in the six months ended June 30, 1998 from $95.1 million in the six months ended June 30, 1997. This increase in costs represents continued growth in outbound traffic on new and existing routes.

Selling, General and Administrative Expenses: Selling, general and administrative expenses as a percentage of revenues were 6.9% in the six months ended June 30, 1998, down from 8.2% in the same period in the prior year. Actual expenses increased 57.3% to $14.9 million in the six months ended June 30, 1998 from $9.4 million in the six months ended June 30, 1997. This increase was due primarily to increased personnel and sales commission expenses. The increase in personnel expenses was directly related to the increase in the number of employees in the Company's wholly owned subsidiaries to 129 at June 30, 1998 from 67 at June 30, 1997. The increase in sales commission expenses was primarily due to increased revenues.

Depreciation: Depreciation increased 93.8% to $4.1 million in the six months ended June 30, 1998 from $2.1 million in the six months ended June 30, 1997. Depreciation as a percentage of revenues was 1.9% of revenue for the six months ended June 30, 1998 and 1997. The increase in the dollar amount was primarily due to depreciation of additional transmission facilities acquired since June 30, 1997.

Income Tax: Income taxes increased to $5.2 million in the six months ended June 30, 1998 from $3.6 million in the six months ended June 30, 1997, primarily due to increased operating income. The effective tax rate was 39.8% in 1997 and 36.0% in 1998. The decrease in effective tax rate was attributable to earnings of certain non-U.S. subsidiaries. A portion of these earnings is intended to be reinvested indefinitely in operations outside the U.S.

Liquidity and Capital Resources

The Company has financed its rapid growth, including its capital expenditures, through funds provided by operations and the funds from the public offering completed in the third quarter of 1996. Due to the timing differences in the international settlement process, the Company's accounts receivable turnover varies from its accounts payable turnover. The length of these turnovers is a function of different timing requirements in the Company's agreements with foreign partners. For example, the length of the Company's accounts payable turnover is partially due to its accounts payable with foreign partners, which generally have 180 day terms as a result of the six-month lag in the international settlement process.

Net cash used in operating activities was $4.4 million for the six months ended June 30, 1998 and $3.5 million for the quarter ended June 30, 1997. This increase in cash used in operating activities was primarily a result of increased accounts receivable balances, which exceeded the cash inflow from greater cash generating net income and higher accounts payable balances.

Net cash used in investing activities was $17.3 million for the six months ended June 30, 1998 and $21.8 million for the six months ended June 30, 1997. Capital expenditures for the first half of 1998 were $14.0 million, down from $22.0 million in the first half of the prior year. Capital expenditures in both 1997 and 1998 were for the acquisition of partial ownership interests in international fiber optic cable

transmission systems and related equipment. In addition, in the first quarter of 1998, the Company acquired 16.66% of Ekonom S.A. de C.V. ("Ekonom"), a Mexican multimedia company, for $3.3 million in cash and $1.8 million in Pacific Gateway's common stock.

Net cash provided by financing activities was $0.3 million for the six months ended June 30, 1998 and $0.1 million for the six months ended June 30, 1997. Substantially all of these cash inflows were from the exercise of stock options.

At June 30, 1998, the Company had outstanding commitments of $11.9 million for the acquisition of additional ownership in digital undersea fiber optic cables and network equipment. Since June 30, 1998, the Company has committed to purchase undersea fiber optic cable in the US-Japan cable network for $86 million. This investment is expected to be expended over the next two years and funded through operating cash flows and existing cash balances. The Company believes that existing cash balances, together with cash provided by operating activities and other existing sources of liquidity, will be sufficient to meet its outstanding capital commitments and its expected capital expenditures and working capital needs through the end of 1998. However, the Company may raise additional funds through offerings of equity or debt securities or other financing arrangements to fund growth opportunities that management believes are beneficial to the Company.

PART II. OTHER INFORMATION

Item 1. Legal proceedings

None

Item 2. Changes in Securities and Use of Proceeds

None

Item 3. Defaults upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

The Company's annual meeting of stockholders was held on June 19, 1998.

The following table sets forth information regarding the number of votes for, against, withheld, or abstaining and broker non-votes, with respect to each matter presented at the meeting.

1. Both nominees for Class I director were elected as follows:

NOMINEES	FOR	WITHHOLD
Charles M. Dalfen	12,123,868	640,490
Barry J. Volante	12,123,868	640,490

2. The amendment to the Company's Certificate of Incorporation to increase the number of authorized shares of Common Stock from Fifty Million (50,000,000) to Seventy Million (70,000,000) shares was approved as follows:

FOR	AGAINST	ABSTAIN	BROKER NON-VOTE
11,573,646	1,185,312	5,550	0

3. The selection of Coopers&Lybrand L.L.P. as the Company's independent auditors for the fiscal year ending December 31, 1998 was approved as follow:

FOR	AGAINST	ABSTAIN	BROKER NON-VOTE
12,742,688	8,220	13,550	50

Item 5. Other Information

None

Item 6. **Exhibits and Reports on Form 8-K**

(a) The Exhibits filed as part of this report are listed below:

10.4	**Proxy dated April 30, 1998 by Gail E. Granton individually and as trustee of The Granton Foundation**
10.5.1	**Employment Agreement effective January 1, 1998 between Howard A. Neckowitz and Pacific Gateway Exchange**
10.5.2	**Employment Agreement effective January 1, 1998 between Gail E. Granton and Pacific Gateway Exchange**
10.5.3	**Employment Agreement effective January 1, 1998 between Ronald D. Anderson and Pacific Gateway Exchange**
10.5.4	**Employment Agreement effective January 1, 1998 between Robert F. Craver and Pacific Gateway Exchange**
10.5.5	**Employment Agreement effective January 1, 1998 between Fred A. Weismiller and Pacific Gateway Exchange**
27	**Financial Data Schedule**

(b) **No reports on Form 8-K have been filed during the quarter ended June 30, 1998**

SIGNATURES

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.

PACIFIC GATEWAY EXCHANGE, INC.

Dated: August 14, 1998

By: /s/ Howard A. Neckowitz
Howard A. Neckowitz
President and CEO
(Authorized Signatory)

By: /s/ Sandra Grey
Sandra Grey
Chief Financial Officer
(Principal Financial and Accounting Officer)

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark one)

(X) **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**

For the fiscal year ended December 31, 1997

OR

( ) **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]**

Commission file number 000-21043

Pacific Gateway Exchange, Inc.
(Exact name of registrant as specified in its charter)

Delaware	**94-3134065**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

533 Airport Boulevard, Suite 505, Burlingame, California 94010
(Address of principal executive offices)

Telephone Number: 650-375-6700
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(g) of the Act:

Common Shares, Par Value $.0001 per Share
Preferred Share Purchase Rights, Par Value $.0001 per Share
(Title of class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

The aggregate market value of voting stock held by non-affiliates of the registrant on March 18, 1998, was approximately $839,000,000, computed upon the basis of the closing sales price of the Common Shares on that date. For the purposes of this computation, shares held by directors (and shares held by any entities in which they serve as officers) and executive officers of the registrant have been excluded. Such exclusion is not intended, nor shall it be deemed to be, an admission that such persons are affiliates of the registrant.

As of March 18, 1998, there were outstanding 19,113,955 Common Shares of $.0001 par value, of the registrant.

Documents Incorporated by Reference

1. The Registrant's definitive proxy statement to be filed with the Securities and Exchange Commission not later than 120 days after the end of the Registrant's fiscal year pursuant to Regulation 14A relating to the 1998 Annual General Meeting of Shareholders.

PACIFIC GATEWAY EXCHANGE, INC.

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PART I

ITEM 1. BUSINESS

Note on forward-looking statements

This Annual Report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding expected future revenue from delayed proportional return traffic from foreign partners pursuant to certain operating agreements. Forward-looking statements are statements other than historical information or statements of current condition. Some forward-looking statements may be identified by use of terms such as "believes," "anticipates," "plans," "intends" or "expects." These forward-looking statements relate to the plans, objectives and expectations of Pacific Gateway Exchange, Inc. ("Pacific Gateway" or the "Company") regarding its future operations or financial performance or related to the Company's expectations regarding the telecommunciations industry. In light of the inherent risks and uncertainties of any forward-looking statement, the inclusion of forward-looking statements in this report should not be regarded as a representation by the Company or any other person that the forward-looking statements will come true. The revenues and results of operations of the Company, and future developments in the telecommunications industry, are difficult to forecast and could differ materially from those projected in the forward-looking statements as a result of numerous factors, including the following: (i) changes in international settlement rates; (ii) changes in the ratios between outgoing and incoming traffic; (iii) foreign currency fluctuations; (iv) termination of certain operating agreements or inability to enter into additional operating agreements; (v) inaccuracies in the Company's forecasts of traffic; (vi) changes in or developments under domestic or foreign laws, regulations, licensing requirements or telecommunications standards; (vii) foreign political or economic instability; (viii) changes in the availability of transmission facilities, such as undersea fiber optic cable; (ix) loss of the services of key officers, such as Howard A. Neckowitz, Chairman of the Board, President and Chief Executive Officer or Gail E. Granton, Executive Vice President, International Business Development and Secretary; (x) loss of a customer which provides significant revenues to the Company; (xi) highly competitive market conditions in the industry; (xii) future management decisions regarding, for example, acquisitions, capital expenditures or financings: (xiii) concentration of credit risk; or (xiv) natural disasters and catastrophic events. The foregoing review of important factors including those discussed in detail below should not be construed as exhaustive; the Company undertakes no obligation to release publicly the results of any future revisions it may make to forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

(a) General Development of Business

Pacific Gateway is a facilities-based international telecommunications carrier, which provides international telecommunications services to its target customer base of long distance service providers worldwide as well as retail customers. The Company is incorporated in Delaware and commenced operations on August 8, 1991. On July 25, 1996, the Company and certain stockholders of the Company consummated an initial public offering of 6,057,050 shares of the Company's Common Stock. As a "facilities-based" carrier, the Company owns or leases its international network facilities including: digital undersea fiber optic cable, international switching facilities and operating agreements with foreign carriers. The Company operates an international network consisting of international and domestic switching facilities in the U.S. in Los Angeles, New York, and Dallas, and offshore in the United Kingdom, New Zealand and Russia. The Company has partial ownership interests in 17 digital undersea fiber optic cable systems in the Atlantic, Pacific and Caribbean regions and operating agreements that provide for the exchange of traffic with foreign carriers.

In 1997, the Company began to provide international long distance services to retail customers through its existing network. In particular, the Company and GMCR Inc. ("Globe Telecom"), a company operating in the Philippines, formed a joint venture called "Pintouch" to market international long distance services to the Filipino-American community.

As of December 31, 1997, Pacific Gateway had 43 operating agreements with foreign carriers in 28 countries around the world, which countries collectively represent approximately 54.3% of U.S.-originated international traffic according to Federal Communications Commission ("FCC") 1996 statistics. The Company's foreign partners include both telecommunications carriers that have been dominant in their home markets, which may be wholly or partially government-owned (often referred to as post telephone and telegraph companies or "PTTs") and non-dominant carriers that may have been recently established as a result of the deregulation of foreign telecommunications markets ("Competitive Carriers").

Industry Background

The international telecommunications market consists of all calls that originate in one country and terminate in another. This market can be divided into two major segments: the U.S.-originated international market (the "U.S.-Originated Market"), consisting of all international calls which either originate or terminate in the United States, and the overseas-originated international market (the "Overseas-Originated Market"), consisting of calls between countries other than the United States. Services offered by international long distance carriers fall into three primary categories: switched services, switch-based value-added services and international private line services.

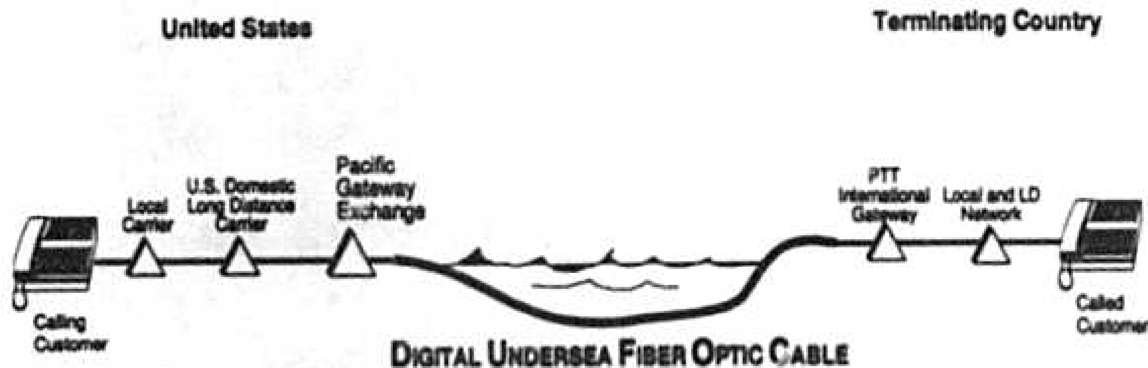
Bilateral operating agreements between international long distance carriers in different countries are key components of the international long distance telecommunications market. Under an operating agreement, each carrier agrees to terminate traffic in its country and provide proportional return traffic to its partner carrier. The implementation of a high quality international network, including the acquisition and utilization of digital undersea fiber optic cable and adherence to the technical recommendations of the International Telegraph and Telephone Consultative Committee (the "CCITT") of the International Telephone Union (the "ITU") for signaling, protocol and transmission, is an important element in enabling a carrier to compete effectively in the international long distance telecommunications market.

The international long distance telecommunications market has experienced rapid growth in recent years. During 1996, according to the FCC, the U.S.-Originated Market grew at an annual rate of 20.7% from $15.9 billion to $19.2 billion. The Company believes that the international telecommunications market will continue to experience strong growth for the foreseeable future as a result of the following trends:

- the opening of overseas telecommunications markets due to deregulation and the privatization of government-owned monopoly carriers, permitting the emergence of new carriers;
- the reduction of international outbound long distance rates, driven by competition and technological advancements, which is making international calling available to a much larger customer base and stimulating increasing traffic volumes;
- the increased availability and quality of digital undersea fiber optic cable in the place of satellite- and analog coaxial cable-based transmission networks, which have enabled long distance carriers to improve the quality of their services and reduce their cost structures;
- the dramatic increases in the availability of telephones and the number of access lines in service around the world, stimulated by economic growth, government mandates and technological advancements;
- the worldwide proliferation of new communications devices such as cellular telephones, facsimile machines and other forms of data communications equipment;
- the rapidly increasing globalization of commerce, trade and travel; and
- the rapidly increasing demand for bandwidth-intensive data transmission services, including the Internet.

Many of the world's developing countries are committing significant resources to build telecommunications infrastructures in order to increase the number and quality of telephone lines in their countries. The Company believes that increasing investment in telecommunications infrastructure will stimulate increasing demand for international telecommunications services. Certain countries have opened their telecommunications markets to competition in order to increase the level of private investment and the rate of infrastructure development. Deregulation of telecommunications services in the United States began in 1984 with the AT&T Communications, Inc. ("AT&T") divestiture. The Company believes that the trend of new international

International Switched Services



Value-Added Services. Value-added services include 800 service, international directory assistance with the option of call completion, travel card services, enhanced facsimile services, videoconferencing and internet access, among others. The provision of such value-added services offers carriers attractive opportunities to increase operating margins and offer a more competitive service to their customers.

International Private Line Services. International private line services provide a dedicated point-to-point connection between two locations without using a public switched network. For example, a typical private line would connect the New York and London branches of an international bank. Customers of this service are typically multinational corporations or government agencies which have substantial communications volume between two or more international locations.

Operating Agreements

International long distance traffic is traditionally exchanged under switched voice bilateral operating agreements between long distance carriers in two countries. In order to terminate a U.S.-originated call in another country, a U.S.-based international carrier may have an operating agreement with a carrier in that country or may pay for transmission service from another carrier that has such an agreement. Typically, operating agreements provide for the termination of traffic in, and return traffic to, the partners' respective countries for mutual compensation through negotiated settlement rates. Operating agreements typically provide that a foreign carrier will return through the U.S. carrier the same percentage of total U.S. terminating traffic as it receives from the U.S.-based carrier and also provide for network coordination and accounting and settlement procedures. The execution of an operating agreement between two carriers is typically accompanied by an equal investment by both carriers in digital undersea fiber optic cable between the two countries. While operating agreements generally are for an unspecified term, the Company believes that the common ownership of transmission facilities, which are expected to have 20-year useful lives, establishes a solid foundation for long-term relationships among international carriers.

Company Strategy

The Company's objective is to strengthen its position as a facilities-based international telecommunications services provider by increasing its customer base in the United States and abroad and positioning itself for continued growth in revenues and profitability. The Company's strategy for achieving this objective consists of the following key elements:

Expand and Enhance Network Facilities

To support the expected growth in data and voice traffic, the Company intends to expand its investment in new and existing digital undersea fiber optic cables. The Company is generally able to provide greater assurance of the quality and reliability of transmission at a cost-effective rate by routing traffic over its owned international facilities. The Company also intends to expand its switching and international gateway facilities in the United States and to invest in network operations in certain foreign locations in order to originate and terminate customer traffic more cost effectively although there can be no assurance the Company will be successful in this expansion. The Company utilizes state-of-the-art equipment and technologies that conform to relevant operating standards to ensure high quality, cost-effective transmission service.

Increase Overseas-Originated Traffic Through International Alliances, Joint Ventures and Acquisitions

The Company believes that alliances and direct investments with foreign partners have the potential to increase the Company's opportunities to increase traffic in the most rapidly growing segments of the international telecommunications market. In July 1996, the Company and Kokusai Denshin Denwa ("KDD Japan") entered into a seven-year cooperation agreement that contemplates joint projects in the communications field, including joint product development of enhanced services, such as imaging and internet services.

In February 1998, the Company acquired 16.66% of the stock of Ekonom S.A. de C.V. ("Ekonom"), a Mexican multimedia and internet telecom provider. The Company intends to use Ekonom's expertise to help it provide a portfolio of multimedia and internet services to its customers. In addition, in conjunction with the acquisition, the Company and Ekonom agreed to enter into an ethnic retail marketing joint venture in order to market telecommunication services to certain ethnic communities although the terms of the joint venture have not yet been finalized.

The Company is currently evaluating several other potential alliances, investment opportunities and acquisitions, including equity positions and operating roles with both established and emerging international telecommunications carriers with operations in Asia, the Pacific Rim, Eastern Europe, Western Europe and Latin America. In many of the regions targeted by the Company, the provision of telecommunications services is being deregulated, providing numerous opportunities either to provide wholesale services to other competitive carriers operating in the region or to service the end-user market directly. Additionally, many of the value-added services currently offered by the Company in the United States (discussed below) can be provided abroad through such alliances, creating opportunities to generate additional revenues through available technology. In 1997, the Company expanded its operations offshore to include the United Kingdom, Russia, and New Zealand. The Company is currently expanding to 4 new offshore locations. In each location the Company is in the process of obtaining the appropriate licenses, and undergoing construction and pre-sales activities. There can be no assurance that the Company will be successful in the expansion to these new locations.

Expand Product Line

The Company intends to expand the range of products and services that it offers to its customers to include international 800 service, prepaid services such as debit and travel cards, international directory assistance with the option of call completion service, enhanced facsimile service and virtual private network services and is in the beginning stages of doing so in some respects. The Company believes that leveraging its existing network by offering additional value-added services will increase the loyalty of its existing customer base and help attract new customers. These services will enable Pacific Gateway's carrier customers to provide a broader range of international services to their end-user customers, which the Company expects will stimulate additional higher margin international traffic over its network.

Secure Additional Operating Agreements

Pacific Gateway actively seeks to enter into additional operating agreements to expand the geographical scope of its international network and to attract new domestic and foreign customers. Pacific Gateway is able to increase the revenues generated by its existing customer base by providing direct service for these customers to additional countries.

Pacific Gateway targets prospective partners for new operating agreements by evaluating customer demand, the relative long-term economic attractiveness of offering direct service to a particular country and the availability of fiber optic or satellite transmission capacity to that country. Currently, the Company is focusing its resources on establishing additional routes primarily to Asia, the Pacific Rim, Eastern Europe and Latin America. The Company believes that these markets, and, in the near future, the Middle East and Africa, offer opportunities for the Company to attain significant market share, improve gross margins, and gain other strategic advantages. In addition, the Company is seeking increased access to more competitive high traffic routes, such as to Western Europe, through strategic relationships with well-established international carriers that offer opportunities to achieve significant revenue growth at relatively low cost. Pacific Gateway believes that the experience, relationships and knowledge of its management team have played, and will continue to play, a key role in enabling the Company to negotiate additional operating agreements in selected markets. The Company also believes that as specific telecommunications markets become less regulated, its management team will be able to use its experience and knowledge to augment existing operating agreements, including by the deployment of telecommunications equipment in foreign countries, resulting in a more efficient world-wide network.

Expand Customer Segments

Pacific Gateway intends to leverage its existing network by marketing international long distance services directly to the retail market, including ethnic marketing. The Company also intends to market its services to targeted customers which have large concentrations of international telecommunications traffic to specific countries where the Company believes that it can offer the combined advantages of competitive prices, high transmission quality and service diversity. The Company expects that traffic generated by retail customers will result in higher gross margins than the Company's wholesale traffic however, selling, general and administrative costs directly related to the provision of these services are also anticipated to increase. To develop this aspect of its business more rapidly, the Company may enter into partnerships or alliances with companies which have an existing customer base that Pacific Gateway intends to target. Examples of this include the October 1997 formation of the Pintouch joint venture between the Company and Globe Telecom to market international long distance services to the Filipino-American community. In addition, in conjunction with the February 1998 acquisition of 16.66% of Ekonom, the Company and Ekonom agreed to enter into an ethnic retail marketing joint venture.

Maintain Efficient Low-Cost Operations

The Company believes it is important to maintain efficient, low-cost operations in order to be competitive in the international wholesale telecommunications services market. Through continuous monitoring of its network, the Company optimizes the routing of calls to decrease transmission costs and obtain the highest possible transmission quality and reliability. The Company pursues a disciplined, incremental approach to the costs of expansion. When Pacific Gateway initially expands sales and services into a region, the Company typically arranges to provide services for that area on a usage-sensitive (variable cost) basis. As volume grows, the Company typically reprovisions its network by acquiring fixed-cost facilities with greater capacity. In addition, the Company closely controls selling, general and administrative costs at levels that it believes are

among the lowest in the industry. The Company intends to maintain a small corporate staff and to continue investing in network technology and information systems that will preserve and enhance its position as a low-cost international telecommunications service provider.

(b) Financial Information About Industry Segments

The Company classifies its operations into one industry segment, telecommunications services.

(c) Narrative Description Of Business

Services

The Company provides four categories of services: international switched services, domestic switched services, switch-based value-added services and international private line services. Substantially all the Company's current revenues are generated by the sale of international and domestic switched services.

International Switched Services

The Company's international switched service revenues are generated from outgoing and incoming international traffic carried through its international network including switching facilities in the United Kingdom, New Zealand and Russia. Revenues from international switched services are derived from country-specific, usage-sensitive rates charged to its customers, return traffic from Pacific Gateway's foreign partners, and terminating traffic in its international switching facilities.

As of December 31, 1997, the Company had 43 operating agreements with foreign carriers in 28 countries under which it carries traffic through its network of switching facilities and digital undersea fiber optic cables, as well as through leased satellite circuits. Through its network and its arrangements with U.S. and foreign carriers, the Company is able to deliver traffic to or between all countries in the world that have direct dial service with the United States. International switched services represented approximately 96.4%, 91.6% and 88.1% of the Company's revenues in 1997, 1996 and 1995, respectively.

Domestic Switched Services

The Company provides both originating and terminating switched long distance services within the United States. The Company's originating network, which provides access and egress to local network providers, extends to geographical areas around its switching facilities in Los Angeles (serving most major metropolitan areas in California, Arizona, and Nevada), New York (serving selected metropolitan locations in New York, Washington, D.C., Massachusetts, Pennsylvania, Connecticut, New Jersey and Virginia) and Dallas (serving metropolitan areas in Texas). The Company provides switched services as a cost-effective means to terminate its return traffic in the mentioned areas and for the U.S., to offer services to U.S.-based long distance resellers that do not own or lease switching facilities ("switchless resellers"). Domestic switched services accounted for approximately 2.6%, 7.4% and 11.7% of the Company's total revenues in 1997, 1996 and 1995 , respectively.

Emerging and Value-Added Services

The Company is broadening its focus to include a variety of emerging and value-added services. The Company is utilizing its existing network to provide international long distance services to certain ethnic retail markets. In particular, the Company and Globe Telecom formed a joint venture called "Pintouch" to market international long distance services to the Filipino-American community. In addition, the Company intends to expand the range of products and services that it offers to include a variety of value-added services including directory assistance, prepaid services such as debit and travel cards, multimedia and internet services to its U.S.-based wholesale carrier customers that do not provide such services directly to their customers. The Company also has international 800 service available in 7 countries. The Company intends to enter the multimedia services

Organization (the "WTO"), which agreement became effective in February 1998. This agreement (the "WTO Agreement") seeks to open markets to competition in telecommunications services, improve foreign investment opportunities in the telecommunications industry and promote pro-competitive regulatory principles. The FCC has adopted various rules designed to implement the principles of the WTO Agreements. See "- Government Regulation." There can be no assurance that the Company will be able to effectively compete in the new regulatory environment or that these changes or other regulatory developments will not have a material adverse effect on the Company's business, financial condition or results of operations.

Government Regulation

Overview

The Company's businesses are heavily regulated. The FCC exercises authority over all interstate and international facilities-based and resale services offered by the Company. Services that originate and terminate within the same state, also known as intrastate services, are regulated by state regulatory commissions. The Company also may be subject to regulation in foreign countries in connection with certain business activities. For example, the Company's use of transit agreements or arrangements, if any, may be affected by regulations in either the transited or terminating foreign jurisdiction.

Federal Regulation

General Requirements. The Company must comply with the requirements of common carriage under the Communications Act of 1934, as amended (the "Communications Act"), including the offering of service on a non-discriminatory basis at just and reasonable rates, and obtaining FCC approval prior to any assignment of authorizations or any transfer of de jure or de facto control of the Company.

The FCC has established different levels of regulation for dominant and non-dominant carriers. The Company is classified as a non-dominant carrier for both domestic and international service. Under the Communications Act and the FCC's rules, all international carriers, including the Company, are required to obtain authority under Section 214 of the Communications Act prior to initiating international common carrier services, and must file and maintain tariffs containing the rates, terms and conditions applicable to their services. The FCC has streamlined its regulation of non-dominant international carriers to provide that these tariffs and any revisions thereto are effective upon one day's notice in lieu of the previous 14-day notice period. The Company has filed international tariffs (for switched and private line services) with the FCC. Nevertheless, an otherwise non-dominant U.S.-based carrier may be subject to dominant carrier regulation on a specific international route if it is affiliated with a foreign carrier with market power operating at the foreign point. The Company is not subject to dominant carrier treatment on any route.

Domestic interstate common carriers such as the Company are not required to obtain Section 214 or other authority from the FCC for the provision of domestic interstate telecommunications services. Domestic interstate carriers must, however, file and maintain tariffs with the FCC containing the specific rates, terms and conditions applicable to their services. These tariffs are effective upon one day's notice. The Company has filed a domestic tariff with the FCC.

In late 1996, the FCC implemented significant changes in its tariff requirements. Exercising forbearance authority granted to it by the Telecom Act, the FCC ruled that non-dominant interexchange carriers are no longer required to file tariffs for domestic services. In August 1997, the FCC affirmed its decision to end tariff filing requirements for domestic interstate long distance services provided by non-dominant carriers. The FCC also eliminated the requirement that non-dominant long distance carriers make publicly available information on rates and terms of their products. The detariffing order has been stayed by the U.S. Court of Appeals for the District of Columbia and the order on reconsideration also is stayed until the Court issues a decision. It is not known when the Court of Appeals will issue a decision.

International Services. The Company must have Section 214 facilities-based authority to offer international services via satellites and undersea fiber optic cables. Section 214 resale authority is required to resell international services. The Company has obtained global Section 214 facilities-based and resale authority.

The Company must conduct its international business in compliance with the FCC's international settlements policy ("ISP"). The ISP establishes the permissible boundaries for U.S.-based carriers and their foreign correspondents to settle the cost of terminating each other's traffic over their respective networks. The precise terms of settlement are established in a correspondent agreement, also referred to as an operating agreement. Among other terms, the operating agreement establishes the types of service covered by the agreement, the division of revenues between the carrier that bills for the call and the carrier that terminates the call at the other end, the frequency of settlements (i.e. monthly or quarterly), the currency in which payments will be made, the formula for calculating traffic flows between countries, technical standards, procedures for the settlement of disputes, the effective date of the agreement and the term of the agreement.

To promote competition in the international telecommunications market, in November 1996, the FCC issued a new international settlement order, which will likely provide international carriers more flexibility in negotiating operating agreements. Under the FCC's new international settlement order, U.S.-based carriers can apply for waivers to the FCC's uniform settlement policy and the FCC's proportionate return policy. Such waivers, if granted, would allow carriers to negotiate more flexible operating agreements. Under the new order, the FCC will no longer apply the ECO Test (defined below) as a threshold for determining when to permit accounting rate flexibility with carriers from WTO member countries. Instead, the FCC adopted a rebuttable presumption that flexibility is permitted for WTO member countries. Although the Company is unable to predict exactly how this new FCC order will affect its international business, the new ISP may reduce international access costs and facilitate the Company's international business.

International telecommunications service providers are required to file copies of their contracts with other carriers, including operating agreements, with the FCC within 30 days of execution. The FCC's rules also require the Company to file periodically a variety of reports regarding its international traffic flows and use of international facilities.

In February 1997, the United States entered in the WTO Agreement, which seeks to open markets to competition in telecommunications services, improve foreign investment opportunities in the telecommunications industry and promote pro-competitive regulatory principles. In June 1997, the FCC proposed to implement new rules in order to comply with the WTO Agreement. These new rules were adopted by the FCC in November 1997 and became effective in February 1998.

The new rules facilitate the entry of foreign carriers that operate in WTO member countries ("WTO Carriers") into the United States telecommunications market. The rules replace the effective competitive opportunities test (the "ECO Test") for entry of WTO Carriers with streamlined procedures that presume entry is pro-competitive. The rules similarly relax the equivalency test for WTO Carriers that seek to provide switched services over private lines between the United States and WTO member countries. In addition, the rules have revised competitive safeguards to eliminate or reduce various operating conditions and replace them with more aggressive safeguards that enhance the FCC's ability to monitor and detect anti-competitive behavior in the United States market. The FCC has retained the right to issue fines, require additional conditions on a grant of authority and, if necessary, deny or rescind a grant of authority.

The FCC also narrowed the "No Special Concessions" rule, which generally provides that United States carriers cannot accept benefits from foreign carriers to which other United States carriers are not entitled. This rule continues to apply to non-WTO Carriers. The new rule applicable to WTO Carriers simply prohibits United States carriers from entering into exclusive arrangements with WTO Carriers that have sufficient market power to affect competition adversely in the United States market. To provide more certainty in the market, the

FCC adopted a rebuttable presumption that WTO Carriers with less than 50% market share in foreign market lack such market power. As a result, United States carriers may enter into exclusive dealings with WTO Carriers involving a variety of matters, including operating agreements and interconnection arrangements.

In addition, in 1997 the FCC revised the safeguards that apply to United States carriers classified as dominant due to an affiliation with a foreign carrier that has market power on the foreign end of an international route. The rules retain a single-tier dominant carrier regulatory approach and rely on reporting requirement, rather than restrictions on carriers' provision of service, to affiliated carriers from restricting competition in the United States. In particular, the rules replace the 14-day advance notice tariff filing requirement with one-day advance notice requirement and accords these tariff filings a presumption of lawfulness. The rules also remove the prior approval requirement for circuit additions or discontinuances on the dominant route. The rules require quarterly reports on traffic and revenue, provisioning and maintenance, and circuit status for the dominant carrier in order to monitor and detect anti-competitive behavior. The rules also require a limited form of structural separation between United States carriers and their foreign affiliates. The FCC adopted a rebuttable presumption that a foreign carrier with less than 50% market share in the foreign market lacks market power and, therefore, its United States affiliate should be presumptively treated as non-dominant.

In August 1997, the FCC adopted mandatory settlement rate benchmarks for carriers receiving traffic from or sending traffic to the United States. These benchmarks are intended to reduce the rates that United States carriers pay foreign carriers to terminate traffic in their home countries. The FCC prohibits a United States carrier affiliated with a foreign carrier from providing facilities-based service to the foreign carrier's home market until and unless the foreign carrier has implemented a settlement rate within the benchmark. In connection with these rules, the FCC also adopted rules that liberalize the provision of switched services over private lines to WTO member countries by allowing such services on routes where 50% or more of United States billed traffic is being terminated in the foreign country at or below the applicable settlement rate benchmark, or where the foreign country's rules concerning the provision of international switched services over private lines are deemed equivalent to United States rules.

The Company is unable to predict the full effect on the international telecommunications market resulting from the WTO Agreement or the rules enacted to implement its provisions or the establishment of mandatory settlement rate benchmarks. These changes are expected to increase competition in the telecommunications market. See "—Competition". These changes may result in lower costs to the Company, however, the revenues that the Company receives from inbound international traffic may decrease to a greater degree as a result of increased competition. WTO Carriers with market power in their home markets may be able to more easily offer United States and foreign customers services to the disadvantage of United States carriers, which may continue to face substantial obstacles in obtaining from foreign governments and foreign carriers the authority and facilities to provide such services. In addition, many foreign carriers are currently challenging the enforceability against such carriers of the FCC's order adopting mandatory settlement rate benchmarks. A finding that this order was unenforceable against such carriers could accelerate the entry of foreign carriers into the United States market by making it easier for foreign carriers to route international traffic to the United States at low, cost-based termination rates, while United States carriers would continue to have to route international traffic into most foreign countries at much higher settlements rates. There can be no assurance that these events would not have a material adverse effect on the Company's business, financial condition or results of operations.

Foreign Ownership. Under the Communications Act, non-U.S. citizens, foreign governments or corporations organized under the laws of a foreign country that is not WTO member country may not (i) directly or indirectly own greater than 25% of an international Section 214 licensee or (ii) indirectly own greater than 25% of a radio licensee, in each case without first obtaining FCC approval after satisfying the ECO Test. For WTO Carriers, the FCC has replaced the ECO Test in favor of an open entry standard, provided that certain competitive safeguards will continue to apply. The FCC has reserved the right in certain cases to attach additional conditions to a grant of authority, and to deny the application in the exceptional case in which an application poses a very high risk to competition.

Federal Legislation and Implementation. The Telecom Act was adopted in February 1996 and substantially changed the regulation of telecommunications in the United States. The Telecom Act permits RBOCs to provide domestic and international long distance services to customers located outside of the RBOCs' home regions; permits a petitioning RBOC to provide domestic and international long distance service to customers within its operating area on a state by state basis upon finding by the FCC that a petitioning RBOC has satisfied certain criteria for opening up its local exchange network to competition and that provision of long distance services would further the public interest; and removes existing barriers to entry into local service markets. Additionally, there were significant changes in: the manner by which carrier-to-carrier arrangements are regulated at the federal and state level; procedure to revise universal service standards; and penalties for unauthorized switching of customers. The FCC has instituted and, in most instances completed, proceedings addressing the implementation of this legislation.

In implementing the Telecom Act, the FCC established nationwide rules designed to encourage new entrants to participate in the local services markets through interconnection with the incumbent local exchange carriers ("ILECs"), resale of ILECs' retail services, and use of individual and combinations of unbundled network elements. These rules set the groundwork for the statutory criteria governing RBOC entry into the long distance market. Appeals of the FCC Order adopting those rules were consolidated before the United States Court of Appeals for the Eighth Circuit (the "Eighth Circuit"). The Eighth Circuit upheld challenges to certain practices implementing cost provisions of the Telecom Act that were ordered by certain state public utility commissions to be premature, but vacated significant portions of the FCC's nationwide pricing rules, and vacated an FCC rule requiring that unbundled network elements be provided on a combined basis. The Solicitor General, on behalf of the FCC, and certain other parties, sought certiorari in the United States Supreme Court, which was granted. Certain RBOCs have also raised constitutional challenges to provisions of the Telecom Act restricting RBOC provision of long distance services, manufacturing of telecommunications equipment, electronic publishing and alarm monitoring services. On December 31, 1997, the United States District Court for the Northern District of Texas ruled that these restrictions violate the Bill of Attainder Clause of the U.S. Constitution. Currently, this decision only applies to SBC Corporation ("SBC"), US West Communications Group ("US WEST") and Bell Atlantic Corporation ("Bell Atlantic"). AT&T, MCI, the U.S. Department of Justice and the FCC announced that they will appeal the decision and sought a stay of the ruling. The Company cannot predict either the ultimate outcome of these or future challenges of the Telecom Act, any related appeals of regulatory or court decisions, or the eventual effect on its businesses or the industry in general.

The FCC has denied applications filed by Ameritech Corporation ("Ameritech"), SBC and BellSouth Corporation ("BellSouth") seeking authority to provide inter-local access transport area ("interLATA") long distance service to Michigan, Oklahoma and South Carolina, respectively. SBC has appealed the FCC's denial of its application to the Eighth Circuit. In its denial of an Ameritech application and a BellSouth application, the FCC provided detailed guidance to applicants regarding the obligations of the applicants, the format of future applications, the content of future applications, and the review standards that it will apply in evaluating any future applications. The National Association of Regulatory Utility Commissioners and several state regulatory commissions have appealed jurisdictional aspects of the Ameritech application denial to the Eighth Circuit. The Company cannot predict either the outcome of these appeals, of the RBOC's willingness to abide by these FCC guidelines, or the timing or outcome of future applications submitted to the FCC. Other RBOCs have announced their intention to file applications at the FCC for authority to provide inter LATA services. The Company cannot predict the outcome of these proceedings. To the extent that the RBOC's are permitted to enter the international long-distance business, they could become major competitors of the Company. It is also possible that they could become customers of the Company's wholesale business although there is no assurance that this would happen.

On May 7, 1997, the FCC announced that it will issue a series or orders that will reform Universal Service Subsidy allocations and adopted various reforms to the existing rate structure for interstate access services provided by the ILECs that are designed to reduce access charges, over time, to more economically efficient levels and rate structures. It also affirmed that information services providers (including, among others, internet service providers ("ISPs") should not be subject to existing access charges ("ISP Exemption"). Petitions for

reconsideration of, among other things, the access service and ISP Exemption related actions were filed before the FCC and appeals taken to various United States Courts of Appeals. On reconsideration, the FCC, in significant part, affirmed the access charge and ISP Exemption actions, and the court appeals have been consolidated before the Eighth Circuit. Also, several state agencies have started proceedings to address the reallocation of implicit subsidies contained in access rates and retail service rates to state universal service funds. Access charges are a principal component of the Company's telecommunications expense. Pacific Gateway cannot predict either the outcome of these appeals or whether or not the result(s) will have a material impact upon the consolidated financial position or the Company's results of operations.

Effect of Foreign Laws of Certain Termination Arrangements

The Company has entered into and expects to continue to enter into certain termination arrangements with alternative foreign carriers that are not the dominant carriers in their respective foreign countries. These arrangements involve the termination of U.S. originated traffic over private leased lines into foreign countries and may be viewed by foreign regulatory agencies as "international simple resale" arrangements. The Company believes that foreign telecommunications regulations are being liberalized and that in the future such arrangements may be expressly approved by foreign regulatory agencies. Nevertheless, at this time the FCC or a foreign regulatory agency in a particular country may take the view that such arrangements are not in compliance with current regulatory policies relating to private line resale. If the FCC finds that such arrangements violate FCC rules, the FCC could impose a variety of sanctions on the Company, including rescission of the Company's Section 214 License. In addition, the operations of alternative Carriers, which compete with the PTT, may not be permitted by foreign regulatory agencies or the PTT may act unilaterally to cancel or eliminate the private line service on which the alternative carrier depends. In 1997, regulatory authorities in Hong Kong and the PTT in Mexico have acted against such arrangements. The alternative foreign carriers with whom the Company enters into such arrangements, and perhaps the Company itself, could be subject to a variety of penalties in connection with such arrangements under foreign or U.S. law, including without limitation orders to cease operations or to limit future operations, loss of licenses or of license opportunities, fines, seizure of equipment and, in certain foreign jurisdictions, criminal prosecution. The revenue and/or profit generated under such arrangements may have become a significant portion of the overall revenue and/or profit of the Company at the time such arrangements are discovered and curtailed. Moreover, the discovery of the existence of such arrangements by foreign PTTs could adversely affect the Company's business relationships with such foreign PTTs. Any of the developments described above (i.e., the imposition of penalties, the loss of revenue and/or profit generated by such arrangements (whether as a result of regulatory problems or otherwise) or the discovery of the existence of such arrangements by foreign PTTs) could have a material adverse effect on the Company's business, operating results and financial condition.

Employees

As of December 31, 1997, Pacific Gateway's wholly-owned subsidiaries had 90 full-time employees, of which 10 were engaged in international relations, 39 in operations, engineering and information systems, 20 in sales, customer support and business development, 21 in administration. The Russian subsidiary of which the company owns a majority interest has 30 employees.

(d) Financial Information About Foreign And Domestic Operations And Export Sales

During 1997, the company developed and acquired offshore subsidiaries in the United Kingdom, New Zealand, Russia, Bermuda and Cyprus. For information regarding foreign and domestic operations and export sales from the U.S. see Note (6) entitled "Segment Data" in the Notes to the Consolidated Financial Statements included in Part II, Item 8 of this 10-K.

Risk Factors

Dependence On Operating Agreements With Foreign Partners

Pacific Gateway's strategy is based on its ability to enter into operating agreements with foreign carriers which the Company refers to as foreign partners, in each of the foreign countries it has targeted so it can

terminate traffic in, and receive return traffic from, that country. The Company believes that it would not be able to serve its customers at competitive prices without such operating agreements. The operating agreements are generally for an unspecified term in accordance with industry practice, although many of the Company's foreign partners have mutual investments with the Company in digital undersea fiber optic cable to assure long-term telecommunications access between their respective countries and the United States. While the Company has been successful in negotiating and maintaining operating agreements, none of which has been terminated to date, the trend toward deregulation of telephone communications in many countries and a significant reduction in outgoing traffic carried by Pacific Gateway, among other things, could cause foreign partners to terminate their operating agreements, or could cause such operating agreements to have substantially less value to the Company. Such termination by certain of the Company's foreign partners could have a material adverse effect on the Company's business. Moreover, there can be no assurance that the Company will be able to enter into additional operating agreements in the future. The failure to enter into additional operating agreements could limit the Company's ability to increase its revenues on a profitable basis.

Managing Rapid Growth

The Company is experiencing a period of rapid growth, which is expected to continue to place a significant strain on the Company's management, operational and financial resources. In order to manage its growth effectively, the Company must continue to implement and improve its operational and financial systems and controls, to purchase and utilize more digital undersea fiber optic cable and other transmission facilities and to expand, train and manage its employee base. Inaccuracies in the Company's forecasts of traffic could result in insufficient or excessive transmission facilities and disproportionate fixed expenses. The Company's overflow traffic is handled by other international carriers to which the Company pays per minute usage fees. The Company is not able to assure that the quality of these services is commensurate with the transmission quality provided by the Company. If the Company is not able to manage its growth effectively or maintain the quality of its service, the Company's business may be adversely affected.

Risks Of International Telecommunications Business

The Company generates a significant portion of its revenues by providing international wholesale telecommunications services to its customers. The Company's operations are subject to certain risks, such as changes in foreign government regulations and telecommunications standards, licensing requirements, tariffs, taxes and other trade barriers, as well as political and economic instability. The Company's revenues and cost of long distance services are sensitive to changes in international settlement rates, changes in the ratios between outgoing and incoming traffic, foreign currency fluctuations, and import and export regulations. International rates charged to customers are likely to decrease in the future for a variety of reasons, including increased competition between existing carriers, new entrants into niche markets and the consummation of joint ventures among large international carriers that facilitate targeted pricing and cost reductions. Furthermore, in the event of any dispute arising from foreign operations, the Company may be subject to the exclusive jurisdiction of foreign courts and may not be successful in subjecting foreign persons or entities to the jurisdiction of the courts in the United States. The Company may also be hindered or prevented from enforcing their rights with respect to foreign governments because of the doctrine of sovereign immunity. There can be no assurance that the laws, regulations or administrative practices of foreign countries relating to the Company's ability to do business in that country will not change. Any such change could have a material adverse effect on the business and financial condition of the Company.

In addition, the Company's business could be adversely affected by a reversal in the current trend toward deregulation of government-owned telecommunications carriers. The rates that the Company can charge its customers for international services may also decrease in the future due to the widespread resale of international private lines to provide switched voice services, the provision of international services via non-traditional means including Internet and the rapid growth of international circuit capacity due to the deployment of new undersea fiber optic cables and new high capacity satellite systems in the Atlantic, Pacific and Indian Ocean regions. There can be no assurance that the Company will be able to increase its traffic volume or reduce its operating costs sufficiently to offset any resulting rate decreases.

The Company has entered into and expects to continue to enter into certain termination arrangements with alternative foreign carriers that are not the dominant carriers in their respective foreign countries. These arrangements involve the termination of U.S. originated traffic over private leased lines in foreign countries and may be viewed by foreign regulatory agencies as "international simple resale" arrangements. The Company believes that foreign telecommunications regulations are being liberalized and that in the future such arrangements may be expressly approved by foreign regulatory agencies. Nevertheless, the FCC or a foreign regulatory agency in a particular country may take the view that such arrangements are not in compliance with current regulatory policies relating to private line resale. If the FCC finds that such arrangements violate FCC rules, the FCC could impose a variety of sanctions on the Company, including rescission of the Company's Section 214 License. In addition, the operations of alternative carriers which compete with the PTT, may not be permitted by foreign regulatory agencies or the PTT may act unilaterally to cancel or eliminate the private line service on which the alternative carrier depends. In 1997, regulatory authorities in Hong Kong and the PTT in Mexico have acted against such arrangements. The alternative foreign carriers with whom the Company enters into such arrangements, and perhaps the Company itself, could be subject to a variety of penalties in connection with such arrangements under foreign or U.S. law, including without limitation orders to cease operations or to limit future operations, loss of licenses or of license opportunities, fines, seizure of equipment and, in certain foreign jurisdictions, criminal prosecution. The revenue and/or profit generated under such arrangements may have become a significant portion of the overall revenue and/or profit of the Company at the time such arrangements are discovered and curtailed. Moreover, the discovery of the existence of such arrangements by foreign PTTs could adversely affect the Company's business relationships with such foreign PTTs. Any of the developments described above (i.e., the imposition of penalties, the loss of revenue and/or profit generated by such arrangements (whether as a result of regulatory problems or otherwise) or the discovery of the existence of such arrangements by foreign PTTs) could have a material adverse effect on the Company's business, operating results and financial condition.

Dependence On Availability Of Transmission Facilities

The future profitability of the Company will depend in part on its ability to obtain transmission facilities on a cost-effective basis. Because digital undersea fiber optic cables typically take several years to plan and construct, carriers generally make investments based on a forecast of anticipated traffic. The Company has not controlled the planning or construction of digital undersea fiber optic transmission facilities. The Company seeks access to such facilities through partial ownership positions. If ownership positions are not available, the Company must seek access to such facilities through lease arrangements on negotiated terms that may vary with industry and market conditions. The Company currently has partial ownership interests in 14 digital undersea fiber optic cable systems. In addition, unlike AT&T, MCI, Sprint and WorldCom, the Company does not have direct access from its gateway switches to the digital undersea fiber optic cable heads, and is required to lease these facilities from competitors of the Company. The cost of leasing access from the Company's gateway switches to the digital undersea fiber optic cable heads is currently approximately less than 1% of the Company's revenue. There can be no assurance of continued availability of transmission facilities or access to digital undersea fiber optic cable heads on economically viable terms.

Competition

The international telecommunications industry is highly competitive and subject to the introduction of new services facilitated by advances in technology. International telecommunications providers compete on the basis of price, customer service, transmission quality, breadth of service offerings and value-added services. The U.S.-based international telecommunications services market is dominated by AT&T, MCI and Sprint. The Company also competes with WorldCom and other carriers in certain markets. As the Company's network expands to serve a broader range of customers, Pacific Gateway expects to encounter increasing competition from these and other major domestic and international communications companies, many of which may have significantly greater resources and more extensive domestic and international communications networks than the Company. Moreover, the Company is likely to be subject to additional competition as a result of the formation of global alliances among the largest telecommunications carriers. The Company also faces competition from companies offering resold international telecommunications services. The Company expects that competition from such

resellers will increase in the future in tandem with increasing deregulation of telecommunications markets worldwide.

The telecommunications industry is in a period of rapid technological evolution, marked by the introduction of new product and service offerings and increasing satellite transmission capacity for services similar to those provided by the Company. Such technologies include satellite-based systems, such as the proposed Iridium and GlobalStar systems, utilization of the Internet for international voice and data communications and digital wireless communication systems such as personal communications services. The Company is unable to predict which of many possible future product and service offerings will be important to maintain its competitive position or what expenditures will be required to develop and provide such products and services. There can be no assurance that the Company will be able to maintain its competitive position in the future.

Recent regulatory changes also are expected to increase competition in the telecommunications industry. In February 1996, the Telecom Act was adopted. The Telecom Act promotes additional competition in the intrastate, interstate and international telecommunications markets by both U.S.-based and foreign companies. The Telecom Act permits the RBOCs to compete in interstate and international service. Some RBOCs have begun to resell international services. AT&T has obtained relaxed pricing restrictions and relief from other regulatory constraints that should make it easier for AT&T to compete with alternative carriers such as the Company. In addition, in February 1997, over 60 countries signed a global agreement on telecommunications under the auspices of the WTO, which agreement became effective in February 1998. The WTO Agreement seeks to open markets to competition in telecommunications services, improve foreign investment opportunities in the telecommunications industry and promote pro-competitive regulatory principles. The FCC has adopted various rules designed to implement the principles of the WTO Agreements See "Business—Government Regulation." There can be no assurance that the Company will be able to effectively compete in the new regulatory environment or that these changes or other regulatory developments will not have a material adverse effect on the Company's business, financial condition or results of operations.

Dependence On Key Personnel

The Company is dependent on the efforts of Howard A. Neckowitz, Chairman of the Board, President and Chief Executive Officer; Gail E. Granton, Executive Vice President, International Business Development and Secretary; Ronald D. Anderson, Vice President, Operations and Engineering; Robert F. Craver, Senior Vice President, International Relations; Fred A. Weismiller, Executive Vice President, International Marketing and Sandra D. Grey, Chief Financial Officer and Vice President, Finance, as well as a group of employees with long-standing industry relationships and technical knowledge of the Company's operations. The loss of the services of one or more of these individuals could materially and adversely affect the business of the Company and its future prospects. The Company does not maintain key person life insurance on any of its officers or employees. The Company's future success will also depend on its ability to attract and retain additional management, technical and sales personnel required in connection with the growth and development of its business.

Capital Expenditures; Potential Need For Additional Financing

The facilities-based telecommunications industry requires substantial capital investment in switching and peripheral equipment and digital undersea fiber optic cables. Growth in the number of minutes transmitted, international locations and customers served by the Company will require additional investment in equipment and facilities. While the Company believes that its existing and anticipated sources of liquidity should be sufficient to fund the capital requirements of its current business for the foreseeable future, certain events may occur that would require the Company to obtain additional financing, which could take the form of the public sale of debt or equity securities. Such events could include acquisitions, the decision to expand investment in facilities, faster than expected growth, or lower than anticipated funds generated from operations. There can be no assurance that the Company will be able to raise additional financing, or, if raised, that the terms of such financing will be favorable to the Company.

Government Regulation

The Company's business is heavily regulated. See "Business—Government Regulation". The Company's interstate and international facilities-based and resale services are subject to regulation by the FCC, and regulations promulgated by the FCC are subject to change in the future. The Company may also be subject to regulation in foreign countries in connection with certain of its business activities. For example, the Company's use of transit agreements or arrangements, if any, may be affected by laws or regulations in either the transited or terminating foreign jurisdiction. There can be no assurance that foreign countries will not adopt laws or regulatory requirements that could adversely affect the Company. There can be no assurance that future regulatory, judicial and legislative changes will not have a material adverse effect on the Company's business, financial condition or results or operation or that regulators or third parties will not raise issues or take enforcement actions with regard to the Company's compliance with applicable regulations.

The telecommunications industry has recently experienced significant regulatory changes designed to open markets to competition in telecommunications services, improve foreign investment opportunities in the telecommunications industry and promote pro-competitive regulatory principles. See "Business—Government Regulation." The Company is unable to predict the full effect of these changes on the international telecommunications market. These changes are expected to increase competition in the telecommunications market. See "—Competition." These changes may result in lower costs to the Company, however, the revenues that the Company receives from inbound international traffic may decrease to a greater degree as a result of increased competition. WTO Carriers with market power in their home markets may be able to more easily offer United States and foreign customers services to the disadvantage of United States carriers, which may continue to face substantial obstacles in obtaining from foreign governments and foreign carriers the authority and facilities to provide such services. In addition, many foreign carriers are currently challenging the enforceability against such carriers of the FCC's order adopting mandatory settlement rate benchmarks. A finding that this order was unenforceable against such carriers could accelerate the entry of foreign carriers into United States market by making it easier for foreign carriers to route international traffic to the United States at low, cost-based termination rates, while United States carriers would continue to have to route international traffic into most foreign countries at much higher settlement rates. There can be no assurance that these events would not have a material adverse effect on the Company's business, financial condition or results of operations.

Foreign Ownership

Under the Communications Act, non-U.S. citizens, foreign governments or corporations organized under the laws of a foreign country that is not WTO member country may not (i) directly or indirectly own greater than 25% of an international Section 214 licensee or (ii) indirectly own greater than 25% of a radio licensee, in each case without first obtaining FCC approval after satisfying the ECO Test. For WTO Carriers, the FCC has recently replaced the ECO Test in favor of an open entry standard, provided, that certain competitive safeguards will continue to apply. See "Business—Government Regulation." This new standard is expected to increase competition in the telecommunications market. See "—Competition." In addition, this standard may make it easier for foreign competitors to acquire customers of the Company, which may result in the migration of those customers from the Company's network and onto the competitors' networks.

Federal Legislation and Implementation

The Telecom Act substantially revises the Communications Act. The legislation is designed to promote competition in all telecommunications markets by, among other things, permitting the FCC to relax regulations for local exchange carriers and other telecommunications carriers where the public interest and competition warrant. To the extent such flexibility is provided, the Company's ability to compete for certain services may be adversely affected. The legislation also provides specific guidelines under which the RBOCs can provide in-region long distance services. Under the Telecom Act, RBOCs are authorized to provide out-of-region services, which permit the RBOCs and other carriers to provide domestic and international long distance services. The

Company's business could be adversely affected by competition from the RBOCs, which typically have greater resources than the Company, and from other carriers that have expanded opportunities to provide domestic and international services.

The Telecom Act also imposes certain requirements on all telecommunications carriers to facilitate the entry of new telecommunications providers. All carriers must permit interconnection of their networks with other carriers and may not deploy network features and functions that interfere with interoperability. The FCC Interconnection Order, which implements the statutory provisions, has not taken effect pending a court challenge brought by certain RBOCs. In addition, the Telecom Act requires all telecommunications providers to contribute equitably to a Universal Service Fund, although the FCC may exempt an interstate carrier or class of carriers if their contribution would be minimal. There can be no assurance that the Company would be exempt from contributing to a Universal Service Fund.

Certain provisions of the Telecom Act could materially affect the growth and operation of the telecommunications industry and the services provided by the Company. There are numerous rulemakings undertaken or to be undertaken by the FCC which will interpret and implement the Telecom Act's provisions. Further, certain of the Telecom Act's provisions have been, and likely will continue to be, judicially challenged. The Company is unable to predict the outcome of such rulemakings or litigation or the substantive effect (financial or otherwise) of the new legislation and the rulemakings on the Company.

In implementing the Telecom Act, the FCC established nationwide rules designed to encourage new entrants to participate in the local services markets through interconnection with the ILECs, resale of ILECs' retail services, and use of individual and combinations of unbundled network elements. These rules set the groundwork for the statutory criteria governing RBOC entry into the long distance market. Appeals of the FCC Order adopting those rules were consolidated before the Eighth Circuit. The Eighth Circuit upheld constitutional challenges to certain practices implementing cost provisions of the Telecom Act that were ordered by certain state public utility commissions to be premature, but vacated significant portions of the FCC's nationwide pricing rules, and vacated an FCC rule requiring that unbundled network elements be provided on a combined basis. The Solicitor General, on behalf of the FCC, and certain other parties, sought certiorari in the United States Supreme Court, which was granted. Certain RBOCs have also raised constitutional challenges to provisions of the Telecom Act restricting RBOC provision of long distance services, manufacturing of telecommunications equipment, electronic publishing and alarm monitoring services. On December 31, 1997, the United States District Court for the Northern District of Texas ruled that these restrictions violate the Bill of Attainder Clause of the U.S. Constitution. Currently, this decision only applies to SBC, US WEST and Bell Atlantic. AT&T, MCI, the U.S. Department of Justice and the FCC announced that they will appeal the decision and sought a stay of the ruling. The Company cannot predict either the ultimate outcome of these or future challenges of the Telecom Act, any related appeals of regulatory or court decisions, or the eventual effect on its businesses or the industry in general.

The FCC has denied applications filed by Ameritech, SBC and BellSouth seeking authority to provide interLATA long distance service to Michigan, Oklahoma and South Carolina, respectively. SBC has appealed the FCC's denial of its application to the Eighth Circuit. In its denial of an Ameritech application and a BellSouth application, the FCC provided detailed guidance to applicants regarding the obligations of the applicants, the format of future applications, the content of future applications, and the review standards that it will apply in evaluating any future applications. The National Association of Regulatory Utility Commissioners and several state regulatory commissions have appealed jurisdictional aspects of the Ameritech application denial to the Eighth Circuit. The Company cannot predict either the outcome of these appeals, of the RBOC's willingness to abide by these FCC guidelines, or the timing or outcome of future applications submitted to the FCC. Other RBOCs have announced their intention to file applications at the FCC for authority to provide inter LATA services. The Company cannot predict the outcome of these proceedings. To the extend that the RBOC's are permitted to enter the international long-distance business, they could become major competitors of the Company. It is also possible that they could become customers of the Company's wholesale business, although there is no assurance that this would happen.

On May 7, 1997, the FCC announced that it will issue a series or orders that will reform Universal Service Subsidy allocations and adopted various reforms to the existing rate structure for interstate access services provided by the ILECs that are designed to reduce access charges, over time, to more economically efficient levels and rate structures. It also affirmed that information services providers (including, among others, ISPs) should not be subject to existing access charges. Petitions for reconsideration of, among other things, the access service and ISP Exemption related actions were filed before the FCC and appeals taken to various United States Courts of Appeals. On reconsideration, the FCC, in significant part, affirmed the access charge and ISP Exemption actions, and the court appeals have been consolidated before the Eighth Circuit. Also, several state agencies have started proceedings to address the reallocation of implicit subsidies contained in access rates and retail service rates to state universal service funds. Access charges are a principal component of the Company's telecommunications expense. Pacific Gateway cannot predict either the outcome of these appeals or whether or not the result(s) will have a material impact upon the consolidated financial position or the Company's results of operations.

In February 1997, over 60 countries signed a global agreement on telecommunications under the auspices of the WTO. The WTO agreement, which became effective on February 5, 1998, seeks to open markets to competition in telecommunications services, improve foreign investment opportunities in the telecommunications industry and to adopt pro-competitive regulatory principles. The Company is unable to predict the effect the WTO agreement will have on the Company.

In sum, there can be no assurance that current laws and FCC and other regulations will not be amended or modified. Any such amendment or modification could have a material adverse effect on the Company's business, results of operations or financial condition.

Effects of Natural Disasters and Other Catastrophic Events

The Company's business is susceptible to natural disasters and catastrophic events such as earthquakes, fire, terrorism and war. Although the Company has taken a number of steps to prevent its network from being affected by natural disasters such as building redundant systems for power supply to the switching equipment, there can be no assurance that any such systems will prevent the Company's switches from becoming disabled in the event of an earthquake, power outage or otherwise. The failure of the Company's network, or a significant decrease in telephone traffic resulting from effects of a natural or man-made disaster, could have a material adverse effect on the Company's relationship with its customers and the Company's business, results of operations and financial condition.

Concentration Of Credit Risk

Seven of the Company's customers accounted for approximately 40% and 52% of gross accounts receivable as of December 31, 1997 and December 31, 1996, respectively. One customer accounted for 10.4% of the Company's 1997 revenues. The Company performs ongoing credit evaluations of its customers but generally does not require collateral to support accounts receivable from its customers. The Company's allowance for doubtful accounts is based on current market conditions. Losses on uncollectible accounts have consistently been insignificant and within management's expectations. However, the failure of any of the Company's large customers to remit payments to the Company due to bankruptcy or otherwise could have a material adverse effect on the Company's business, financial condition and results of operations.

Anti-Takeover Provisions

The Company's Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock (the "Preferred Stock") and to determine the price, rights, preferences and privileges of those shares without any further vote or actions by the stockholders. The rights of the holders of Common Stock will be subject to, and may be adversely affected by, the rights of the holders of any Preferred Stock that may be issued in the future. The issuance of shares of Preferred Stock, while potentially providing desirable flexibility in connection with possible acquisitions and serving other corporate purposes, could have the effect of making it more difficult for a third party to acquire, or may discourage a third party from attempting to acquire, a majority of the outstanding

voting stock of the Company. In addition, the Company is subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which prohibits the Company from engaging in a "business combination" with an "interested stockholder" for a period of three years after the date of the transaction in which the person became an interested stockholder unless the business combination is approved in a prescribed manner. The application of Section 203 also could have the effect of delaying or preventing a change of control of the Company. Furthermore, certain provisions of the Company's bylaws, including provisions that provide that the exact number of directors shall be determined by a majority of the Board of Directors and that vacancies on the Board of Directors may be filled by a majority vote of the directors then in office, though less than a quorum, may have the effect of delaying or preventing a change in control of the Company, which could adversely affect the market price of the Company's Common Stock. In addition, the Company adopted a stockholders rights plan (the "Stockholders Rights Plan") in November 1997 and in connection therewith entered into a Rights Agreement between the Company and Norwest Bank Minnesota N.A., as Rights Agent, dated as of November 17, 1997, which will cause substantial dilution to a person or group that attempts to acquire the Company on terms not approved by the Company's Board of Directors. These provisions, along with the adoption of the Stockholders Rights Plan, may discourage takeover bids for the Company. See Note (11) in the Notes to the Consolidated Financial Statements included in Part II, Item 8 of this 10-K for further information on the Stockholders' Rights Plan.

Influence of Company by Pre-Initial Public Offering Shareholders

Stockholders of the Company who owned shares of Common Stock prior to the Company's initial public offering ("Original Stockholders") in the aggregate still own and control a significant portion of the outstanding shares of Common Stock although, as a result of sales pursuant to Rule 144, their collective ownership has been reduced during 1997. As a result of their ownership of shares of Common Stock, these stockholders of the Company, to the extent acting together, may influence the management and policies of the Company. Through direct ownership of shares owned and proxies to vote, Mr. Neckowitz has the right to vote a substantial percentage of the outstanding shares of Common Stock of the Company.

Shares Eligible for Future Sale

Future sales of Common Stock in the public market by the Original Stockholders of the Company could adversely affect the market price for the Common Stock. As of March 18, 1998, there were 19,113,955 shares of Common Stock outstanding that could be sold in the public market, subject to limitations contained in Rule 144 under the Securities Act of 1933, as amended. The volume limitations of Rule 144 will apply to the sale of these shares as long as the shares are held by affiliates of the Company or in the case of Original Stockholders who are not affiliates, until the requisite holding period under Rule 144 has been met. Sales of substantial amounts of shares of Common Stock in the public market, or even the potential for such sales, could adversely affect the prevailing market price of the Common Stock and impair the Company's ability to raise capital through the sale of equity securities.

Possible Volatility of Stock Price

Historically, the market prices for securities of emerging companies in the telecommunications industry have been highly volatile. Future announcements concerning the Company or its competitors, including results of operations, technological innovations, government regulations, proprietary rights or significant litigation, may have a significant impact on the market price of the Company's Common Stock.

Dividend Policy

The Company has never paid cash dividends on its Common Stock and has no plans to do so in the foreseeable future. The Company intends to retain earnings to develop and expand its business.

ITEM 2. PROPERTIES

The principal offices of the Company are located in 12,950 square feet of space in Burlingame, California. The Company leases this space under an agreement which expires in April 1999. The Company also leases a total of approximately 40,000 square feet in the U.S. in the cities of New York, Los Angeles and Dallas and in the United Kingdom, New Zealand and Russia as sites for its switching facilities. In addition, the Company leases a total of approximately 3,000 square feet of office space in Houston, Texas, Tarzana, California and Riverside, California for its operations. The Company believes that its facilities are adequate to support its current needs and that suitable additional facilities will be available, when needed, on commercially reasonable terms.

ITEM 3. LEGAL PROCEEDINGS

The Company is not currently subject to any material legal proceedings.

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

No matters were submitted to a vote of shareholders of the Company during the fourth fiscal quarter of the fiscal year ended December 31, 1997.

EXECUTIVE OFFICERS

Set forth below are the names, ages, positions and certain other information concerning the current executive officers and other key members of management of the Company.

The executive officers of the Company are as follows:

Name	Age	Position
Howard A. Neckowitz	44	President and Chief Executive Officer
Gail E. Granton	42	Executive Vice President, International Business Development and Secretary
Sandra D. Grey	31	Chief Financial Officer and Vice President, Finance
Ronald D. Anderson	41	Senior Vice President, Operations and Engineering
Robert F. Craver	55	Senior Vice President, International Relations
Fred A. Weismiller	56	Executive Vice President, International Marketing

MR. HOWARD A. NECKOWITZ has served as President, Chief Executive Officer and Chairman of the Board of the Company since its inception in August 1991. Mr. Neckowitz previously served as a consultant to major U.S. and overseas telecommunications companies with respect to valuation and due diligence processes for the acquisition of ongoing foreign telecommunications operations and the start-up of competitive carrier operations for international, long distance, local and cellular operations in various countries. Prior to his consulting experience, Mr. Neckowitz served from 1982 to 1986 as Director, International Services, at GTE Sprint, where he founded and developed GTE Sprint's international services operation. In this position he was responsible for feasibility analyses supporting GTE Sprint's entrance into the international switch service market. From 1977 to 1982, Mr. Neckowitz worked at AT&T in its Overseas Department.

MS. GAIL E. GRANTON has served as Executive Vice President, International Business Development, Secretary and a member of the Board of Directors of the Company since its inception in August 1991. From August 1991 to August 1996, she served as Chief Financial Officer of the Company. From 1986 to August 1991, Ms. Granton served as a consultant to major U.S. and overseas telecommunications companies, focusing on the valuation and due diligence process for the acquisition of ongoing foreign telecommunication operations and the start-up of competitive carrier operations for international, long distance, local and cellular operation in various countries. From 1982 to 1986, Ms. Granton worked in the International Department of GTE Sprint as a Manager, International Business Development, reporting to Mr. Neckowitz.

MS. SANDRA D. GREY has served as Chief Financial Officer of the Company since 1996. From 1989 to 1996, Ms. Grey worked for Telecom New Zealand, the primary provider of telecommunications services in New Zealand, where she was Chief Financial Officer of the international subsidiary. Ms. Grey has more than 8 years experience in international telecommunications.

MR. RONALD D. ANDERSON has served as Senior Vice President, Operations and Engineering of the Company since December 1992. From 1986 to 1992, Mr. Anderson served in a similar position with TRT International, Inc., an international telecommunications carrier that has since been acquired by WorldCom. Mr. Anderson has more than 16 years of experience in domestic and international telecommunications engineering and operations, with significant experience in international signaling and transmission for cable and satellite, PTT technical interface and bilateral technical negotiations.

MR. ROBERT F. CRAVER has served as Senior Vice President, International Relations of the Company since February 1994. Prior to joining the Company, Mr. Craver worked at GTE Hawaiian Telephone Co., Inc. from 1987 to 1994. While at GTE Hawaiian Telephone, Mr. Craver directed that company's international program as Director of International Services. Mr. Craver has also held international positions at Sprint and AT&T, for a total of more than 21 years of experience in the international telecommunications industry. Mr. Craver has extensive experience in international negotiations with foreign partners and has served as an officer of the Pacific Telecommunications Council.

MR. FRED A. WEISMILLER joined the Company in November 1994 as Executive Vice President, International Marketing. Mr. Weismiller's responsibilities include developing the valued-added long distance services which can be sold to U.S. carriers and to carriers in developing overseas markets. From 1991 to 1994, Mr. Weismiller served as Managing Director and Executive Director, Sales and Marketing at Telecom New Zealand. Mr. Weismiller has 26 years of experience in international and domestic telecommunications management, including 20 years with AT&T, where his final assignment was in Hong Kong as the Managing Director of the AT&T Regional Technical Center from 1989 to 1990.

PART II

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

The Common Shares were initially offered to the public on July 19, 1996 at a price of $12.00 per share. The Common Shares are quoted on the NASDAQ National Market under the symbol "PGEX."

The following table sets forth, for the periods indicated, the high and low sales prices for the Common Shares as reported by the NASDAQ National Market. Such prices reflect inter-dealer prices, without retail mark-up, mark-down or commission, and do not necessarily represent actual transactions.

	High	Low
Quarter ended September 30, 1996 (from July 19, 1996)	$31.000	$12.000
Quarter ended December 31, 1996	$37.125	$25.875
Quarter ended March 31, 1997	$39.250	$22.500
Quarter ended June 30, 1997	$29.000	$21.750
Quarter ended September 30, 1997	$39.375	$27.000
Quarter ended December 31, 1997	$55.125	$33.000

As of March 18, 1998 there were 97 holders of record of the Common Shares of the Company.

The Company has never paid cash dividends on its Common Stock and has no plans to do so in the foreseeable future. The Company intends to retain earnings, to develop and expand its business.

ITEM 6. SELECTED FINANCIAL DATA

The following selected consolidated financial data as of and for each of the five years in the period ended December 31, 1997 have been derived from the audited Consolidated Financial Statements of the Company. The following data should be read in conjunction with the Consolidated Financial Statements and the notes thereto and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included herein.

	Year Ended December 31,				
	1993	1994	1995	1996	1997
	(In thousands except per share amounts)				
Statement of Operations Data:					
Revenues	$5,048	$20,913	$76,416	$162,426	$ 298,609
Cost of long distance services	4,036	17,196	66,346	140,340	254,076
Gross margin	1,012	3,717	10,070	22,086	44,533
Selling, general and administrative expenses	1,008	2,273	5,467	11,113	21,416
Depreciation	104	410	1,124	2,044	5,417
Operating income (loss)	(100)	1,034	3,479	8,929	17,700
Other expense/(income), net	—	—	—	129	(126)
Interest expense/(income), net	12	193	538	(885)	(2,009)
Income (loss) before income taxes	(112)	841	2,941	9,685	19,835
Provision for income taxes	—	205	1,155	3,877	7,338
Net income (loss)	($ 112)	$ 636	$ 1,786	$ 5,808	$ 12,497
Net income (loss) per share—diluted	($0.01)	$ 0.04	$ 0.12	$ 0.34	$ 0.64
Weighted average shares outstanding—diluted	14,300	14,300	14,535	16,872	19,497

	Year Ended December 31,				
	1993	1994	1995	1996	1997
	(In thousands except revenues per minute of use amounts)				
Other Operating Data:					
EBITDA (1)	$ 4	$ 1,444	$ 4,603	$ 10,973	$ 23,117
Capital Expenditures	$1,542	$ 3,745	$ 7,233	$ 18,669	$ 36,725
Minutes of use	13,580	61,690	252,925	563,495	1,025,649
Revenues per minute use	$ 0.37	$ 0.34	$ 0.30	$ 0.29	$ 0.29
Estimated return traffic revenue backlog (2)	$ 158	$ 986	$ 6,142	$ 13,719	$ 10,685

	As of December 31,				
	1993	1994	1995	1996	1997
Balance Sheet Data					
Cash and cash equivalents	$ 63	$ 9	$ 1,792	$ 45,563	$ 43,850
Working capital (deficit)	(865)	242	(6,412)	35,051	(14,541)
Total assets	4,130	12,301	29,976	103,816	171,617
Revolving line of credit	—	—	3,000	—	—
Revolving line of credit, related party	718	4,488	2,420	—	—
Stockholders' equity	468	1,104	2,891	62,472	76,573

(1) EBITDA represents earnings before interest expense, income taxes, depreciation and amortization expense. EBITDA does not represent cash flows as defined by generally accepted accounting principles and does not necessarily indicate that cash flows are sufficient to fund all of the Company's cash needs. EBITDA is a financial measure commonly used in the Company's industry and should not be considered in isolation or as a substitute for net income, cash from operating activities or other measures of liquidity determined in accordance with generally accepted accounting principles.

(2) Represents management's estimates of the revenue to be received from delayed proportional return traffic that are based on the anticipated ratios between outgoing and incoming traffic and the anticipated settlement rates. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Overview."

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Note on forward-looking statements

This Annual Report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements regarding expected future revenue from delayed proportional return traffic from foreign partners pursuant to certain operating agreements. Forward-looking statements are statements other than historical information or statements of current condition. Some forward-looking statements may be identified by use of terms such as "believes," "anticipates," "plans," "intends" or "expects." These forward-looking statements relate to the plans, objectives and expectations of Pacific Gateway regarding its future operations or financial performance or related to the Company's expectations regarding the telecommunications industry. In light of the inherent risks and uncertainties of any forward-looking statement, the inclusion of forward-looking statements in this report should not be regarded as a representation by the Company or any other person that the forward-looking statements will come true. The revenues and results of operations of the Company, and the future developments in the telecommunications industry are difficult to forecast and could differ materially from those projected in the forward-looking statements as a result of numerous factors, including the following: (i) changes in international settlement rates; (ii) changes in the ratios between outgoing and incoming traffic; (iii) foreign currency fluctuations; (iv) termination of certain operating agreements or inability to enter into additional operating agreements; (v) inaccuracies in the Company's forecasts of traffic; (vi) changes in or developments under domestic or foreign laws, regulations, licensing requirements or telecommunications standards; (vii) foreign political or economic instability; (viii) changes in the availability of transmission facilities, such as undersea fiber optic cable; (ix) loss of the services of key officers, such as Howard A. Neckowitz, Chairman of the Board, President and Chief Executive Officer or Gail E. Granton, Executive Vice President, International Business Development and Secretary; (x) loss of a customer which provides significant revenues to the Company; (xi) highly competitive market conditions in the industry; (xii) future management decisions regarding, for example, acquisitions, capital expenditures or financings (xiii) concentration of credit risk or (xiv) natural disasters and catastrophic events. The foregoing review of important factors including those discussed in detail below should not be construed as exhaustive; the Company undertakes no obligation to release publicly the results of any future revisions it may make to forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Overview

Pacific Gateway was founded in August 1991 to capitalize on the significant growth opportunities in the international telecommunications services market. The Company operates an international network consisting of international and domestic switching facilities in the U.S in New York, Los Angeles, and Dallas and offshore in the United Kingdom, New Zealand and Russia. The Company has partial ownership interests in 17 digital undersea fiber optic cables systems in the Atlantic, Pacific and Caribbean regions and operating agreements with foreign carriers that provide for the exchange of telecommunications traffic. As of December 31, 1997, the Company had 43 operating agreements in 28 countries around the world, which provide for the exchange of telecommunications traffic with these carriers. The Company's revenues are derived primarily from the sale of international telecommunications services to U.S.-based carriers on a wholesale basis and from the traffic received by the Company under operating agreements with its foreign partners. In addition, the Company has begun to recognize revenue from retail customers generated by Pintouch the Company's joint venture with Globe Telecom.

The majority of the Company's costs are variable and consist of payments to foreign partners for the termination of traffic, payments to other providers of long distance services for transmission services to countries where the Company does not have operating agreements, payments to domestic carriers for the termination of overseas-originated traffic in the United States where the Company does not have its own domestic network and

payments to local exchange companies for access charges for originating and terminating international and domestic traffic where the Company has its own domestic network. The Company generally enters new markets by establishing operating agreements with foreign partners and by investing in or leasing digital undersea fiber optic cable in order to cost effectively carry and terminate traffic. The Company seeks to have ownership positions in cable systems where it believes its customers' demand will justify the investment in those fixed assets. Although the Company is generally able to earn a higher gross margin on traffic routed through its owned circuits relative to leased routes, Pacific Gateway will continue to buy usage-sensitive transmission capacity on a per minute basis from other U.S. facilities-based international carriers on routes where traffic volumes are relatively low or inconsistent, as well as to manage overflow traffic on busy routes.

Under its operating agreements, the Company typically agrees to send U.S.-originated traffic to its foreign partners and its foreign partners agree to send a proportionate amount of return traffic via the Company's network at negotiated rates. These agreements contractually obligate the foreign partners to adhere to the policy of the FCC, whereby traffic from the foreign country is routed to U.S.-based international carriers, such as the Company, in the same proportion as traffic carried into the foreign country. The Company and its foreign partners typically settle the amounts owed to each other in cash on a net basis, subsequent to the receipt of return traffic. The Company records the amount due to the foreign partners as an expense in the period the Company's traffic is delivered.

Of the Company's operating agreements in service as of December 31, 1997, 18 agreements provide that the Company must wait up to six months before it actually receives the proportional return traffic. The delay period between the Company's delivery of U.S.-originated traffic and the receipt of the proportional return traffic enables the carriers to determine the appropriate traffic exchange ratio based on the Company's relative market share on a particular route. As a result, the Company delivers outbound traffic and generally recognizes a loss in the period in which it sells to its customers because amounts due to foreign partners generally exceed revenues from customers on outbound traffic. The Company then recognizes revenues with minimal associated cost on the associated return traffic on a six-month delayed basis. The rates that the Company charges its customers are established at a level such that the Company expects to recognize a gross profit on the combined transactions.

The following table sets forth income statement data as a percentage of revenues for the period indicated.

	Year Ended December 31,		
	1997	1996	1995
Total revenues	100.0%	100.0%	100.0%
Cost of long distance services	85.1%	86.4%	86.8%
Gross margin	14.9%	13.6%	13.2%
Selling, general and administrative expenses	7.2%	6.8%	7.2%
Depreciation	1.8%	1.3%	1.5%
Total operating expenses	9.0%	8.1%	8.7%
Operating income	5.9%	5.5%	4.5%
Other (income)/expenses, net	0.0%	0.0%	0.0%
Interest (income)/expense, net	(0.7%)	(0.5%)	0.7%
Income before income taxes	6.6%	6.0%	3.8%
Provision for income taxes	2.4%	2.4%	1.5%
Net income	4.2%	3.6%	2.3%

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

Revenues: Total revenues in 1997 increased 83.8% to $298.6 million from $162.4 million in 1996. The increase was primarily the result of an active U.S. market and growth of the Company's offshore sites in the U.K., Russia and New Zealand. Sales to existing customers increased as the number of operating agreements

grew to 43 at December 31, 1997 from 30 at December 31, 1996. The total number of customers worldwide increased to 125 at December 31, 1997 from 75 at December 31, 1996. As a result, total minutes have increased 82% from last year while the average price per minute charged to customers remained unchanged at 29 cents. During 1997 prices generally declined in the markets in which the Company principally operates and may decline further in the future. However, the Company's average price per minute remained unchanged from 1996 because the company was able to increase traffic to markets offering higher prices. The change in the terminating country mix with significantly different rates per minute, the reduction in the rates received for the traffic terminating in and transiting the United States and the increase in the incidental United States domestic terminating traffic, are factors influencing the average customer price per minute.

Gross margin: Gross margin as a percentage of revenues increased from 13.6% in the prior year to 14.9% in the current year, primarily because the Company generally paid lower access rates to foreign carriers than it paid in 1996 and because in certain countries the competition for call termination has intensified and resulted in lower termination costs for Pacific Gateway and similar companies. Because the same rate is charged by the foreign carrier to terminate calls in its country as Pacific Gateway charges to terminate calls in the United States, declining rates have an adverse effect on revenue. However, because the Company sends more minutes to foreign partners than it receives from them, declining rates improve the Company's gross margin received on its transactions with such foreign carriers.

Gross margin as a percentage of revenue was lower during the second half of 1997 primarily because the Company's revenues increased significantly from $114.6 million for the first half of 1997 to $184.0 million for the second half of 1997. Significant revenue increases generally reduce the Company's short-term gross margin for two reasons, which again took effect in the second half of 1997. First, to terminate the additional traffic efficiently, the Company incurs the expense of building new facilities and reconfiguring its U.S. network. Second, until such can be achieved, the Company has no choice but to terminate the additional traffic over less efficient, higher cost routes. Margins on the additional revenue are expected to improve as the Company begins to terminate the new traffic more efficiently, but this margin improvement may be offset in future periods [illegible] sharp revenue increases, expenses for the new facilities, competitive pricing pressures and other factors. The [illegible] of long distance service increased to $254.1 million for the year ended December 31, 1997 from $140.3 mil[illegible] December 31, 1996.

Selling General and Administrative Expenses: As a percentage of revenues, selling, ge[illegible] administrative expenses increased from 6.8% in the prior year to 7.2% in the current year and the actual expense increased 92.7% to $21.4 million from $11.1 million. This increase was due primarily to increased personnel as the number of employees grew to 90 from the Company's wholly-owned subsidiaries and to 30 from its majority owned Russian subsidiary at December 31, 1997 from 49 at December 31, 1996. In addition, the Company incurred higher sales commission expenses due to increased revenues.

Depreciation: Depreciation increased 165% to $5.4 million in 1997 from $2.0 million in 1996 representing 1.8% of 1997 total revenues. The increase in the dollar amount was primarily due to depreciation of additional transmission facilities acquired during 1997.

Interest (income) expense, net: Interest income increased 127% to $2.0 million in 1997 from $0.9 million in 1996. The increase was primarily due to the Company having on average $30 million in cash or cash equivalents during 1997 as compared to on average $15 million in cash or cash equivalents during 1996.

Income Tax: Income taxes increased to $7.3 million from $3.9 million, primarily due to increased operating income. The effective tax rate was 37% in 1997 and 40% in 1996. The decrease in the effective tax rate was attributable to earnings of certain non-U.S. subsidiaries. A portion of these earnings are intended to be reinvested indefinitely in operations outside the U.S.

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

Revenues: Total revenues in 1996 increased 113% to $162.4 million from $76.4 million in 1995. The increase was primarily the result of both increased sales to existing customers, due to an increase in the number of operating agreements to 30 at December 31, 1996 from 21 at December 31, 1995 and a 70% increase in the

number of wholesale carrier customers to 75 at December 31, 1996 from 44 at December 31, 1995. As a result, total minutes increased 123% from 1995 while the average price per minute charged to customers slightly declined to 29 cents compared to 30 cents in 1995. The revenue from Matrix increased to $20.5 million, or 12.6% of revenue, in 1996 from $17.2 million, or 22.5% of revenue, in 1995. See Note (5) in the Notes to Consolidated Financial Statements included in Part II, Item 8 of this 10-K for further information regarding the Company's transactions with Matrix.

Gross margin: Gross margin increased 119.3% to $22.1 million in 1996 from $10.1 million in 1995. As a percentage of revenue, gross margin increased from 13.2% in 1995 to 13.6% in 1996. This increase resulted from savings derived from a reduction in the transit or resale rates on the routes in which the Company did not have a direct operating agreement, a reduction in the foreign access charges on the routes in which the Company had a direct operating agreement and a reduction in the domestic termination rates in the United States. These savings were offset by the effects of an increase in the estimated return traffic revenue backlog, which adversely effects the current gross margin. The cost of long distance service increased to $140.3 million for the year ended December 31, 1996 from $66.3 million at December 31, 1995. This increase in costs represented growth in outbound traffic on new and existing routes in advance of receiving proportional return traffic, resulting in an increase in the estimated delayed proportional return traffic backlog amount at December 31, 1996.

Selling General and Administrative Expenses: As a percentage of revenues, selling, general and administrative expenses decreased from 7.2% in 1995 to 6.8% in 1996 and the actual expenses increased 103.3% to $11.1 million from $5.5 million. This increase was due primarily to increased personnel and sales commission expenses. The increase in personnel expenses was directly related to the increase in employees to 49 at December 31, 1996 from 28 at December 31, 1995. The increase in sales commission expenses was primarily due to increased revenues.

Depreciation: Depreciation increased 82% to $2.0 million in 1996 from $1.1 million in 1995. As a percentage of revenues, depreciation was 1.3% of revenue for the year ended December 31, 1996, and 1.5% in 1995. The increase in the dollar amount was primarily due to depreciation of additional transmission facilities acquired during 1996.

Interest (income) expense, net: The Company had interest income of $0.9 million in 1996 compared to interest expense of $0.5 million in 1995. This was due to the successful completion of the initial public offering in July 1996 resulting in the Company having $45.5 million in cash or cash equivalents and no line of credit outstanding at December 31, 1996 compared to $1.8 million of cash and $5.5 million owing under the lines of credit available to the Company at December 31, 1995.

Income Tax: Income taxes increased to $3.9 million from $1.2 million, primarily due to increased operating income. The effective tax rate was 40% in 1996 and 39.3% in 1995.

Liquidity and Capital Resources

The Company has financed its rapid growth, including its capital expenditures, through funds provided by operations and the funds from the public offering completed in the third quarter of 1996. Due to the timing differences in the international settlements, the Company's accounts receivable turnover varies from its accounts payable turnover. The length of these turnovers is a function of different timing requirements in the Company's agreements with foreign partners. For example, the length of the Company's accounts payable turnover is partially due to its accounts payable with foreign partners, which generally have 180 day terms as a result of the six-month lag in the international settlement process.

Net cash provided by operating activities increased to $34.2 million for the year ended December 31, 1997, from $13.9 million and $7.4 million for the years ended December 31, 1996 and 1995. The increases in 1997 and 1996 were primarily a result of an increase in net income as well as accounts payable, which exceeded the increases in accounts receivable.

Net cash used in investing activities increased to $36.5 million in 1997, from $18.4 million in 1996 and $6.5 million in 1995. The expenditures in all three years were primarily for the acquisition of partial ownership interests in international fiber optic cable transmission systems and related equipment.

Net cash provided by financing activities was $0.5 million in 1997, $48.3 million in 1996 and $0.9 million in 1995. During the third quarter of 1996, the Company completed an initial public offering of 6,057,050 shares of Common Stock, of which 4,940,050 shares were offered by the Company, which provided the Company with net proceeds of approximately $54.1 million. The Company used $3.3 million of the proceeds to repay an outstanding line of credit with a major shareholder of the Company.

The deficit in working capital excluding cash at December 31, 1997 was $29.3 compared to a deficit of $10.5 million at December 31, 1996 and $7.7 million at December 31, 1995. This is due to the significant delay that occurs in both paying and receiving cash for the minutes sent and received from overseas. This is partially offset by the estimated return traffic revenue backlog of $10.7 million at December 31,1997, compared to $13.7 million at December 31, 1996 and $6.1 million at December 31, 1995.

At December 31, 1997, the Company had outstanding commitments of $11.8 million for the acquisition of additional ownership in digital undersea fiber optic cables and network equipment. The Company believes that existing cash balances, together with cash provided by operating activities and other sources of liquidity, will be sufficient to meet its outstanding capital commitments, current capital expenditures and working capital needs through the end of 1998. However, the Company may raise additional funds through offerings of equity or debt securities or other financing arrangements to fund growth opportunities that management believes are beneficial to the Company.

Impact of the Year 2000

The Company has assigned resources to review all systems and selected computer applications to access their ability to process transactions in the Year 2000. The Company is still in the process of determining the extent of systems modifications and/or computer software upgrades needed to ensure the systems will properly utilize dates beyond December 31, 1999. The Company has not yet determined the total cost of such modifications and/or upgrades.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTAL DATA

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders
of Pacific Gateway Exchange, Inc.

We have audited the accompanying consolidated balance sheets of Pacific Gateway Exchange, Inc. and subsidiaries as of December 31, 1997 and 1996, and the related statements of operations, cash flows and changes in stockholders' equity for each of the three years in the period ended December 31, 1997. We have also audited the financial statement schedule listed in Item 14(a) of the Form 10-K. These financial statements and financial schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Pacific Gateway Exchange, Inc. and subsidiaries as of December 31, 1997 and 1996, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles. In addition, in our opinion, the financial statement schedule referred to above, when considered in relation to the basic financial statements taken as a whole, present fairly, in all material respects, the information required to be included therein.

/s/ COOPERS & LYBRAND L.L.P.

San Francisco, California
February 16, 1998

PACIFIC GATEWAY EXCHANGE, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands)

	December 31, 1997	December 31, 1996
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 43,850	$ 45,563
Accounts receivable, net of allowance for doubtful accounts of $2,230 in 1997 and $1,679 in 1996	62,313	25,145
Accounts receivable, related party	—	3,066
Prepaids	511	729
Deferred income tax	1,096	1,184
Other current assets	673	—
Total current assets	108,443	75,687
Property and Equipment:		
Undersea fiber optic cables	31,144	13,393
Long distance communications equipment	30,535	13,744
Computers and office equipment	6,343	1,317
Leasehold improvements	702	45
Construction in progress	1,849	2,837
	70,573	31,336
Less accumulated depreciation	9,140	3,700
Total property and equipment, net	61,433	27,636
Deposits and other assets	1,741	493
Total assets	$171,617	$103,816
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 87,949	$ 36,472
Accrued liabilities	3,733	1,304
Income taxes payable	1,491	2,493
Current portion of capitalized lease obligations	216	—
Other liabilities	513	367
Total current liabilities	93,902	40,636
Long-term portion of capitalized lease obligations	185	—
Deferred income tax	957	708
Total liabilities	95,044	41,344
Commitments and contingencies (Note 7).		
Stockholders' Equity:		
Preferred stock, $.0001 par value, authorized 5,000,000 shares, no shares issued	—	—
Common stock, $.0001 par value, authorized 50,000,000, issued 19,216,710, outstanding 19,073,150 shares in 1997; and issued 19,040,050, outstanding 18,896,490 shares in 1996	2	2
Additional paid in capital	60,849	55,113
Deferred compensation—restricted stock	(4,134)	—
Foreign currency translation	2	—
Retained earnings	20,254	7,757
Cost of common stock held in treasury, 143,560 shares in 1997 and 1996	(400)	(400)
Total stockholders' equity	76,573	62,472
Total liabilities and stockholders' equity	$171,617	$103,816

See Accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

	Year Ended December 31,		
	1997	1996	1995
Revenues	$298,609	$141,912	$59,250
Revenues—related party	—	20,514	17,166
Total revenues	298,609	162,426	76,416
Cost of long distance services	254,076	140,340	66,346
Gross margin	44,533	22,086	10,070
Selling, general and administrative expenses	21,416	11,113	5,467
Depreciation	5,417	2,044	1,124
Total operating expenses	26,833	13,157	6,591
Operating income	17,700	8,929	3,479
Interest (income) expense, net	(2,009)	(885)	538
Other (income) expense, net	(126)	129	—
Income before income taxes	19,835	9,685	2,941
Provision for income taxes	7,338	3,877	1,155
Net income	$ 12,497	$ 5,808	$ 1,786
Net income per share—basic	$ 0.66	$ 0.36	$ 0.13
Net income per share—diluted	$ 0.64	$ 0.34	$ 0.12
Weighted average number of common shares outstanding—basic	18,960	16,234	14,100
Weighted average number of common shares outstanding—diluted	19,497	16,872	14,535

See Accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
(in thousands)

	Year Ended December 31,		
	1997	1996	1995
Operating Activities:			
Net income	$12,497	$ 5,808	$1,786
Adjustments to net income:			
Depreciation	5,417	2,044	1,124
Loss on sale of stock	—	129	—
Stock compensation expense	146	85	—
Bad debts provision	2,173	855	687
Changes in operating assets and liabilities:			
Accounts receivable	(38,681)	(13,421)	(9,436)
Accounts receivable, related party	3,066	196	(1,059)
Notes and advances receivable	—	175	(175)
Prepaid expenses	306	(729)	—
Deferred tax asset	88	(816)	(314)
Deposits and other assets	(1,430)	(107)	(243)
Accounts payable	48,309	17,053	12,782
Accrued liabilities	2,429	532	700
Federal income taxes payable (recoverable)	(462)	1,758	790
Other liabilities	150	(152)	519
Deferred tax liability	249	488	220
Net cash provided by operating activities	34,257	13,898	7,381
Investing Activities:			
Purchase of property and equipment	(36,725)	(18,669)	(7,233)
Other investing activities	222	274	702
Net cash used in investing activities	(36,503)	(18,395)	(6,531)
Financing Activities:			
Proceeds from issuance of common stock	—	55,130	—
Payment of issuance costs	—	(1,042)	—
Payment to acquire treasury stock	—	(400)	—
Borrowings on revolving lines of credit	—	3,200	4,000
Repayments on revolving lines of credit	—	(6,200)	(3,067)
Borrowings on revolving lines of credit, related party	—	3,000	—
Repayments on revolving lines of credit, related party	—	(5,420)	—
Exercise of stock options	742	—	—
Repayments on capital lease obligations	(209)	—	—
Net cash provided by financing activities	533	48,268	933
Net increase in cash and cash equivalents	(1,713)	43,771	1,783
Cash and cash equivalents at beginning of the period	45,563	1,792	10
Cash and cash equivalents at end of the period	$43,850	$45,563	$1,792
Supplementary Information:			
Interest paid during period	$ —	$ 276	$ 576
Income taxes paid during period	$ 7,841	$ 2,447	$ 683

See Accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(In thousands)

	Common Stock		Additional Paid-in Capital	Deferred Compensation-Restricted Stock	Foreign Currency Translation	Retained Earnings	Treasury Stock		Total
	Shares	Amount					Shares	Amount	
Balance December 31, 1994	15	$—	$ 942	$ —	$—	$ 163	—	$ —	$ 1,105
940 to 1 stock split	14,085	1	(1)	—	—	—	—	—	—
Net income	—	—	—	—	—	1,786	—	—	1,786
Balance December 31, 1995	14,100	1	941	—	—	1,949	—	—	2,891
Repurchase of common stock	—	—	—	—	—	—	(144)	(400)	(400)
Issuance of common stock, net of $1,042 issuance costs	4,940	1	54,087	—	—	—	—	—	54,088
Stock option compensation expense	—	—	85	—	—	—	—	—	85
Net income	—	—	—	—	—	5,808	—	—	5,808
Balance December 31, 1996	19,040	2	55,113			7,757	(144)	(400)	62,472
Stock options exercised	102	—	742	—	—	—	—	—	742
Stock option compensation expense	—	—	146	—	—	—	—	—	146
Tax effect on stock option exercise	—	—	714	—	—	—	—	—	714
Restricted stock compensation expense	—	—	4,134	—	—	—	—	—	4,134
Deferred compensation - restricted stock	75	—	—	(4,134)	—	—	—	—	(4,134)
Foreign currency translation	—	—		—	2	—	—	—	2
Net income	—	—	—	—	—	12,497	—	—	12,497
Balance December 31, 1997	19,217	$ 2	$60,849	$ (4,134)	$ 2	$20,254	(144)	$(400)	$76,573

See Accompanying Notes to Consolidated Financial Statements.

PACIFIC GATEWAY EXCHANGE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) The Company and Significant Accounting Policies

Description of Business and Organization:

Pacific Gateway Exchange, Inc. ("Pacific Gateway" or the "Company"), a Delaware corporation, owns and operates an international switched and domestic switched telecommunications network. The operations of Pacific Gateway have grown significantly as the result of entering into additional operating agreements with foreign partners and marketing to certain long distance companies in the United States which do not have their own international network.

The Company is subject to various risks in connection with the operation of its business. These risks include, but are not limited to, government regulations, dependence on transmission facilities-based carriers and suppliers, price competition and competition from larger industry participants.

Principles of Consolidation:

Consolidated Financial Statements include the accounts of Pacific Gateway and majority-owned and controlled subsidiaries principally in the United Kingdom, Russia, New Zealand, Bermuda and Cyprus. Investments in 20% to 50%-owned or affiliated are accounted for on the equity method. Intercompany transactions have been eliminated.

Foreign Currency Translation:

Assets and liabilities of operations outside the United States, except for operations in highly inflationary economies (principally in Russia) are translated into U.S. dollars using the exchange rate in effect at each period end. Revenues and expenses are translated at the average exchange rate prevailing during the period. The effects of foreign currency translation adjustments arising from differences in exchange rates from period to period are deferred and included as a component of "Stockholders' Equity". The effects of foreign currency transactions, and of remeasuring the financial position and results of operations in the functional currency, are included in "Selling general and administrative expenses." Operations in highly inflationary economies are maintained in the reporting currency, U.S. dollars.

Estimates:

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

Cash and Cash Equivalents:

Cash equivalents consist primarily of money market accounts and called bonds with maturities of three months or less. The carrying amount reported in the accompanying balance sheet approximates fair market value.

Property and Equipment:

Property and equipment are stated at cost. Depreciation is provided for financial reporting purposes using the straight-line method over the following estimated useful lives:

Undersea fiber optic cables	20 years
Long distance communications equipment	5-7 years
Computers and office equipment	4-7 years
Leasehold improvements	term of lease

Maintenance and repairs are expensed as incurred. Replacements and betterments are capitalized. The cost and related accumulated depreciation of assets sold or retired are removed from the account balance, and any resulting gain or loss is reflected in results of operations.

Income Taxes:

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes." SFAS No. 109 has as its basic objective the recognition of current and deferred income tax assets and liabilities based upon all events that have been recognized in the financial statements as measured by the provisions of the enacted tax laws.

Valuation allowances are established when necessary to reduce deferred tax assets to the estimated amount to be realized. Income tax expense represents the tax payable for the current period and the change during the period in the deferred tax assets and liabilities.

Revenue Recognition:

Revenues for telecommunications services provided to customers are recognized as services are rendered. Revenues for return traffic received according to the terms of the Company's operating agreements with its foreign partners are recognized as revenue as the return traffic is received.

Earnings Per Share:

The Company adopted SFAS No. 128 "Earnings Per Share" effective December 31, 1997. In accordance with SFAS No. 128, basic earnings per share is calculated by dividing net income by the weighted-average number of shares outstanding for the period. Diluted earnings per share is calculated by dividing net income by the weighted average number of shares outstanding during the period plus the dilutive effect of stock options determined using the treasury stock method. The earnings per share calculation has been adjusted for all periods presented to reflect the 940 to 1 stock split effected October 20, 1995.

There were no adjustments to net income in the calculation of basic and diluted earnings per share for the years ended December 31, 1997, 1996 and 1995, respectively. The reconciliation of the weighted average shares outstanding used in calculating basic and diluted earnings per share is as follows:

	Income (Numerator)	Shares (Denominator)	Per-Share Amount
1997			
Basic EPS:			
Income available to common stockholders	$12,497,000	18,960,000	$0.66
Effect of dilutive stock options		537,000	
Diluted EPS	$12,497,000	19,497,000	$0.64
1996			
Basic EPS:			
Income available to common stockholders	$ 5,808,000	16,234,000	$0.36
Effect of dilutive stock options		638,000	
Diluted EPS	$ 5,808,000	16,872,000	$0.34
1995			
Basic EPS:			
Income available to common stockholders	$ 1,786,000	14,100,000	$0.13
Effect of dilutive stock options		435,000	
Diluted EPS	$ 1,786,000	14,535,000	$0.12

Fair Value of Financial Instruments:

The carrying amounts for accounts receivable and accounts payable approximate their fair value.

Concentration of Credit Risk:

Financial instruments that potentially subject the Company to concentration of credit risk consist of cash and cash equivalents, and accounts receivable. At December 31, 1997 and 1996, the Company had bank deposits in excess of federally insured limits of $43,650,000 and $45,381,000, respectively. Seven of the Company's customers accounted for approximately 40% and 52% of gross accounts receivable as of December 31, 1997 and 1996, respectively. The Company performs ongoing credit evaluations of its customers but generally does not require collateral to support customer receivables. The Company's allowance for doubtful accounts is based on current market conditions. Losses on uncollectible accounts have consistently been within management's expectations.

Financial Statement Classifications:

Certain prior-year amounts have been reclassified to conform to the 1997 financial statement presentation. Such reclassifications have no effect on net income as previously reported.

(2) Accounting for International Long Distance Traffic

The Company has entered into operating agreements with 43 telecommunications carriers in 28 countries under which international long distance traffic is both delivered and received. Under these agreements, the foreign carriers are contractually obligated to adhere to the policy of the Federal Communications Commission (the "FCC"), whereby traffic from the foreign country is routed to international carriers, such as the Company, in the same proportion as traffic carried into the country. Mutually exchanged traffic between the Company and foreign carriers is settled through a formal settlement policy that generally extends over a six-month period at an agreed upon rate. The Company records the amount due to the foreign partner as an expense in the period the traffic is delivered. Of the 43 agreements the Company had at December 31, 1997, 18 agreements provided that the Company generally must wait up to six months before it actually receives the proportional return traffic. Under these agreements, the Company recognizes a loss in the period in which it originates a call from a customer because the amount due to the foreign partner generally exceeds the amount the Company charges its customers. As a result, a significant increase in traffic with one or more of the carriers with which the Company must wait up to six months to receive return traffic may cause the Company to report a net loss in the accounting period in which such increase occurred. Historically, when the return traffic is received in the future period, the Company generally realizes a gross margin on the return traffic that, when combined with the prior period loss on the outbound traffic, results in a gross profit on the total transaction. In circumstances where the Company does not receive the return traffic due from the foreign partner at the end of the agreed-upon delayed return period, the Company and the foreign partner may agree to a settlement which compensates the Company for the return traffic not received, through greater return traffic in future periods, or a reduction to the Company's current accounts payable balance. Although the Company can reasonably estimate the revenue it will receive under the FCC's proportional share policy, there is no guarantee that there will be traffic delivered back to the United States or what impact changes in future settlement rates will have on net payments made and revenue received.

The tax effect of significant temporary differences, which comprise the deferred tax assets and liabilities, are as follows:

	Year Ended December 31,		
	1997	1996	1995
Deferred tax assets:			
Allowance for doubtful accounts	$ 696,831	$ 861,768	$325,613
State taxes	316,574	210,647	—
Other	83,088	111,548	42,185
Total gross deferred tax assets	$1,096,492	$1,183,963	$367,798
Deferred liabilities:			
Depreciation	$ 870,566	$ 707,518	$219,551
Other	85,811	—	—
Total gross deferred tax liabilities	$ 956,377	$ 707,518	$219,551
Net deferred tax assets	$ 140,115	$ 476,445	$148,247

(4) Acquisition of Rustelnet

In 1997, the Company acquired a majority interest in Rustelnet, a provider of enhanced telecommunications services to the Russian market. The acquisition was accounted for by the purchase method and accordingly the results of operations of the acquired business have been included in the accompanying consolidated financial statements from the date of acquisition. The price was $36,000 with Rustelnet having cash balances of $257,000 at the time. The fair value of net liabilities acquired in the acquisition was $158,000. The excess of purchase price over the estimated fair market value of $627,000 has been allocated to goodwill. Goodwill is being amortized on a straight-line basis over a 10-year period.

(5) Related Party Transactions

The Company provides certain domestic and international switched telecommunications services to Matrix Telecom, Inc. ("Matrix"), which is a switchless reseller. In 1996 and 1995, a significant (greater than 10%) shareholder in the Company also owned a controlling interest in Matrix. See Note 6 for the amount of revenues recorded from providing these services for the years ended December 31, 1996 and 1995. In 1997, the shareholder sold shares of the Company's common stock and currently owns less than 10%. Accordingly, ongoing transactions with Matrix are no longer disclosed as related party transactions.

In February 1995, the Company accepted certain shares of common stock, with a fair market value of approximately $702,000, of a customer as payment for accounts receivable totaling $702,000. The Company then sold this stock to a significant shareholder for $702,000. The shareholder subsequently sold the stock over a period of several months for a total of $730,000.

In connection with the acquisition of Rustelnet (see Note 4), the Company purchased Rustelnet shares from individual shareholders who are members of Pacific Gateway's management. A total of 690 Rustelnet shares were sold by management to the Company for $13,000.

PACIFIC GATEWAY EXCHANGE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(6) Segment Data

The Company classifies its operations into one industry segment, telecommunications services. Export sales were $83,875,000, $46,522,000, and $17,619,000 for the years ended December 31, 1997, 1996 and 1995 respectively. Export sales by geographic area were as follows:

	Year Ended December 31,		
	1997	1996	1995
Pacific Rim	$22,577,000	$20,653,000	$10,066,000
Europe	44,292,000	17,134,000	4,798,000
Canada	11,015,000	6,449,000	2,418,000
Other	5,991,000	2,286,000	337,000
Total export sales	$83,875,000	$46,522,000	$17,619,000

The Company's domestic and foreign operations are as follows:

	United States	Other	Corporate & Eliminations	Consolidated
1997				
Sales to unaffiliated customers	$280,870,000	$17,739,000	$ —	$298,609,000
Sales and transfers between geographic areas	12,066,000	12,005,000	(24,071,000)	—
Total sales	$292,936,000	$29,744,000	$(24,071,000)	$298,609,000
Operating income	$ 15,720,000	$ 1,193,000	$ (42,000)	$ 16,871,000
Identifiable assets	$183,312,000	$32,542,000	$(36,869,000)	$178,985,000
1996				
Sales to unaffiliated customers	$141,912,000	$ —	$ —	$141,912,000
Sales and transfers between geographic areas	—	—	—	—
Total sales	$141,912,000	$ —	$ —	$141,912,000
Operating income	$ 8,929,000	$ —	$ —	$ 8,929,000
Identifiable assets	$103,816,000	$ —	$ —	$103,816,000
1995				
Sales to unaffiliated customers	$ 59,250,000	$ —	$ —	$ 59,250,000
Sales and transfers between geographic areas	—	—	—	—
Total sales	$ 59,250,000	$ —	$ —	$ 59,250,000
Operating income	$ 3,479,000	$ —	$ —	$ 3,479,000
Identifiable assets	$ 29,976,000	$ —	$ —	$ 29,976,000

Other includes operating subsidiaries located in the United Kingdom, Russia, New Zealand and Cyprus. United States includes all remaining operations of the Company. Transfers between geographic areas are accounted for at cost plus a reasonable profit. Identifiable assets are those assets identified in the operations in each area or segment, including goodwill.

The Company sells to long distance international telecommunications companies, to foreign partners and to retail customers. At December 31, 1997, the Company had 43 operating agreements and approximately 125 worldwide customers. Ten percent or more of the Company's revenues have been derived from the following customers.

	Year Ended December 31,		
	1997	1996	1995
Frontier Communications, Inc.	$30,996,068	(A)	(A)
Matrix Telecom, Inc. (See Note 5)	(A)	$20,514,040	$17,165,995

(A) Sales were less than 10% of total sales.

(6) Commitments and Contingencies

Litigation

The Company is not currently subject to any legal proceedings that will have a material impact on the Company's financial position or results of operations.

Leases

The Company leases office space and equipment under noncancelable operating leases. Rental expenses for 1997, 1996 and 1995 were $965,000, $255,000 and $142,000, respectively. The Company leases certain computer equipment under an agreement that is classified as a capital lease. The lease has a term of three years with a minimum purchase price at the end of the lease. Leased capital assets included in property and equipment at December 31, 1997 were $610,000.

Future minimum lease payments under operating and capital leases as of December 31, 1997 are as follows:

	Operating leases	Capital leases
1998	$1,040,000	$216,000
1999	603,000	216,000
2000	507,000	8,000
2001	467,000	—
2002	437,000	—
Thereafter	2,200,000	—
Total minimum lease payments	$5,254,000	$440,000
Amount representing interest		39,000
Present value of net minimum payments		$401,000
Current portion		$216,000

Employment Agreements

The Company has entered into employment agreements with certain employees which provide that in the event of a change in control each of such employees would be entitled to severance following their resignation from the Company. Should such an event occur, the Company's aggregate obligation for severance would be $1,173,000. Upon any such change in control, each individual would also receive full vesting of any outstanding stock options. In 1998, the Company entered into new agreements with certain employees which would increase the Company's aggregate obligation for severance by approximately $1,603,000.

Commitments

At December 31, 1997 the Company had outstanding commitments of $11,800,000 for the acquisition of additional ownership interests in digital undersea fiber optic cables and the expansion of existing switch sites.

(8) Employee Benefit Plans

In September 1995, the Company established an Employee Stock Purchase Plan (the "Purchase Plan") which is meant to qualify under section 423 of the Internal Revenue Code. It is intended for the Purchase Plan to become effective during 1998. Under the Purchase Plan, the Company reserved up to 400,000 shares of common stock for purchase by employees who meet certain eligibility requirements. Eligible employees may contribute up to 10% of their compensation to the Purchase Plan to purchase shares at 85% of the fair market value of the stock on the first or last day of each six-month offering period as defined in the Purchase Plan.

In 1996, the Company adopted a 401(k) plan pursuant to which eligible employees may accumulate savings on a tax-deferred basis. Each year the Company may make a discretionary profit sharing contribution to the 401(k) plan which will be allocated to the accounts of eligible employees who are employed on the last day of the year. The profit sharing allocation is made on a pro rata basis in proportion to the compensation of the eligible employees. The Company did not make a contribution in 1997 or 1996.

(9) Stock Option Plan

On September 30, 1995, the Company adopted the 1995 Stock Option Plan (the "1995 Plan"). The 1995 Plan provides for the granting of nonqualified and incentive stock options to purchase up to 1,200,000 shares of common stock. Options granted under the 1995 Plan generally vest over four years and must be exercised within five years. The maximum term of options granted is ten years. The Company granted options to purchase 883,411 shares of common stock under the 1995 Plan.

On February 17, 1997, the Company adopted the 1997 Long-Term Incentive Plan (the "1997 Plan"), replacing the 1995 Plan. The 1997 Plan provides for the granting of awards of nonqualified and incentive stock options, stock appreciation rights, stock grants or stock-based performance units. Awards may be made under the 1997 Plan with respect to 4,000,000 shares of common stock and with respect to stock option and stock appreciation right awards, no more than 500,000 shares may be awarded to any one individual in any one-year period. The remaining terms of the 1997 Plan are similar to those described in the 1995 Plan. The Company granted options to purchase 1,610,000 shares of common stock in 1997 under the 1997 plan.

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees", and related interpretations in accounting for its stock-based compensation plans. Accordingly, no compensation expense has been recognized for its plans. Had compensation cost for the Company's stock option plans been determined based upon the fair value at the grant date for awards under these plans consistent with the methodology prescribed under SFAS No. 123, "Accounting for Stock-Based Compensation", the Company's earnings per share would have been reduced to the pro forma amounts indicated below:

	Year Ended December 31,		
	1997	1996	1995
Net income—as reported	$12,497,000	$5,808,000	$1,786,000
Net income—pro forma	$11,469,000	$5,244,000	$1,636,000
Earnings per share—basic as reported	$ 0.66	$ 0.36	$ 0.13
Earnings per share—basic pro forma	$ 0.60	$ 0.32	$ 0.12
Earnings per share—diluted as reported	$ 0.64	$ 0.34	$ 0.12
Earnings per share—diluted pro forma	$ 0.59	$ 0.31	$ 0.11

(10) Capital Stock

On September 30, 1995, the Company's Board of Directors authorized management to file a registration statement with the Securities and Exchange Commission to permit the Company to sell shares of its common stock to the public. On September 30, 1995, the Company's Board of Directors authorized an amendment to the Certificate of Incorporation which was approved by the shareholders on the same date. The amendment effected a 940 to 1 split of the Company's Common Stock and adjusted the authorized shares to 25,000,000 shares of common stock, $.0001 par value per share, and 1,000,000 shares of Preferred Stock, $.0001 par value per share. The 940 to 1 split was effective October 20, 1995. The rights, preferences and limitations of the Preferred Stock may be designated by the Company's Board of Directors at any time.

On July 19, 1996, the Company completed an initial public offering of 6,057,050 shares of common stock of which 4,940,050 were offered by the Company and 1,116,550 shares were offered by certain selling shareholders. The net proceeds to the Company (after deducting underwriting discounts and estimated offering expenses) from the sale of the shares was approximately $54.1 million.

(11) Stockholders' Rights Plan

On November 17, 1997, the Board of Directors of the Company declared a dividend of one preferred share purchase right (a "Right") for each outstanding share of Common Stock. Subject to certain exceptions, each Right, when exercisable, entitles the registered holder to purchase from the Company one one-thousandth of a share of Series A Junior Participating Preferred Stock, par value $0.0001 per share (the "Preferred Stock"), of the Company at a price of $20[illegible], subject to adjustment (the "Purchase Price").

The Rights generally will only be exercisable (i) ten days following a public announcement that a person or group of affiliated or associated persons (an "Acquiring Person") has acquired, or obtained the right to acquire, 15% or more of the outstanding shares of the Company's Common Stock or (ii) 15 business days following commencement of (or an announcement of an intention to make) a tender or exchange offer for 15% or more of the outstanding shares of the Common Stock. The Rights will expire, if not previously exercised, exchanged or redeemed, on December 1, 2007.

If any person or group generally acquires 15% or more of the Company's outstanding Common Stock, each Right, except those held by such an Acquiring Person, would entitle each holder of a Right to acquire, upon exercise at the then current exercise price of the Right, Common Stock having a value equal to two times the exercise price of the Right.

At anytime after a person or group generally acquires more than 15% of the outstanding Common Stock and prior to their acquisition of 50% or more of the outstanding Common Stock, each Right, except those held by such an Acquiring Person, may be exchanged by the Board of Directors for one share of Common Stock.

If the Company is acquired in a merger or other business combination transaction or 50% or more of the Company's assets or earnings power is sold, each Right will entitle the holder thereof (except for the Acquiring Person) to receive, upon exercise at the then current exercise price of the Right, common stock of the acquiring or surviving company having a value equal to two times the exercise price of the Right.

At any time prior to the time an Acquiring Person becomes such, the Board of Directors may redeem the Rights in whole, but not in part, at a price of $.01 per Right (the "Redemption Price").

PACIFIC GATEWAY EXCHANGE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

(12) New Accounting Pronouncements

In June 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income". SFAS No. 130 establishes standards for reporting and display of comprehensive income and its components in a financial statement that is displayed with the same prominence as other financial statements. Comprehensive income as defined includes all changes in equity (net assets) during a period from nonowner sources. Examples of items to be included in comprehensive income, which are excluded from net income, include foreign currency translation adjustments. Management is currently evaluating the financial statement and disclosure impact of the adoption of SFAS No. 130. The disclosures prescribed by SFAS No. 130 must be made beginning with the quarter ended March 31, 1998

In June 1997, the FASB issued SFAS No. 131, "Disclosures about Segments of an Enterprises and Related Information". This statement establishes standards for the way companies report information about operating segments in annual financial statements. It also establishes standards for related disclosures about products and services, geographic areas, and major customers. The Company is in the process of evaluating the disclosure impact of adopting this new standard. The disclosures prescribed by SFAS No. 131 must be made for the year ended December 31, 1998.

(13) Subsequent Event

On February 13, 1998, the Company purchased of 16.6% of Ekonom S.A. de C.V., a Mexican multimedia company existing under the laws of the United Mexican States, for $3,600,000 in cash and $1,800,000 in Pacific Gateway's stock. The Company's investment in Ekonom will be accounted for the under the cost method in 1998.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS

The information concerning directors required by this item is incorporated by reference to the information contained under the captions "Election of Directors", "Meetings and Committees of the Board" and "Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's Proxy Statement for the 1998 Annual Meeting of Stockholders.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is incorporated by reference to the information contained under the caption "Compensation of Directors and Executive Officers" in the Company's Proxy Statement for the 1998 Annual Meeting of Stockholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this item is incorporated by reference to the information contained under the caption "Ownership of the Capital Stock of the Company" in the Company's Proxy Statement for the 1998 Annual Meeting of Stockholders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is incorporated by reference to the information contained under the caption "Certain Relationships and Related Transactions" in the Company's Proxy Statement for the 1998 Annual Meeting of Stockholders.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a)1. **Financial Statements***

Consolidated Balance Sheets as of December 31, 1997 and 1996

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

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

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

Notes to Consolidated Financial Statements

* Included in Item 8 of this 10-K

(a)2. **Financial Statement Schedule**

Schedule II Valuation and Qualifying Accounts

3. **Exhibits**

Exhibit Number	Description	Method of Filing
3.1	Amended and Restated Certificate of Incorporation, as amended May 20, 1997	Incorporated by reference to Quarterly Report on Form 10-Q for the quarter ended June 30, 1997 (No. 000-21043)
3.2	Amended and Restated Bylaws, as amended December 30, 1997	Filed with this document
4.1	Specimen Certificate for Common Stock	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
4.2	Amended and Restated Certificate of Incorporation, as amended May 20, 1997	Incorporated by reference to Quarterly Report on Form 10-Q for the quarter ended June 30, 1997 (No. 000-21043)
4.3	Rights Agreement dated as of November 17, 1997, between the Company and Norwest Bank Minnesota, N.A. as Rights Agent	Incorporated by reference to Form 8-K filed November 21, 1997 (No. 000-21043)
10.1	Form of Indemnification Agreement for directors and officers	Filed with this document
10.2	1997 Long-Term Incentive Plan	Incorporated by reference to Quarterly Report on Form 10-Q for the quarter ended June 30, 1997 (No. 000-21043)
10.3	Employee Stock Purchase Plan	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.4.1	Proxy dated December 10, 1994 by Julie J. Jensen	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.4.2	Proxy dated December 10, 1994 by Jeffrey J. Jensen	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.4.3	Proxy dated December 10, 1994 by Janet Jensen Kreiger	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.4.4	Proxy dated December 10, 1994 by James J. Jensen	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.4.5	Proxy dated December 10, 1994 by Jami J. Jensen	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.4.6	Proxy dated May 10, 1996 by Gail E. Granton	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.4.7	Proxy dated June 10, 1996 Ronald L. Jensen	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.5.1	Employment Agreement dated October 1, 1995 between Howard A. Neckowitz and Pacific Gateway Exchange, Inc.	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)

Exhibit Number	Description	Method of Filing
10.5.2	Employment Agreement dated October 1, 1995 between Gail E. Granton and Pacific Gateway Exchange, Inc.	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.5.3	Employment Agreement dated as of October 1, 1995 between Ronald D. Anderson and Pacific Gateway Exchange,Inc.	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.5.4	Employment Agreement dated October 1, 1995 between Robert F. Craver and Pacific Gateway Exchange, Inc.	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.5.5	Employment Agreement dated October 1, 1995 between Fred A. Weismiller and Pacific Gateway Exchange, Inc.	Incorporated by reference to Annual Report on Form 10-K for the year ended December 31, 1996 (No. 000-21043)
10.5.6	Restricted Stock Award Agreement dated December 30,1997 between Howard A. Neckowitz and Pacific Gateway Exchange, Inc.	Filed with this document
10.6	Telephone Service dated May 1, 1995 between Matrix Telecom, Inc. and Pacific Gateway Exchange, Inc.	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.7	Agreement for Billing Services dated November 24, 1995 Between Matrix Telecom, Inc. and Pacific Gateway Exchange, Inc.	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
10.8	Form of Stock Purchase Agreement with KDD	Incorporated by reference to Registration Statement on Form S-1 (No. 33-80191)
21.1	Subsidiaries	Filed with this document
23.1	Consent of Independent Accountants	Filed with this document
27.1	Financial Data Schedule	Filed with this document

(b) **Reports on Form 8-K**

Stockholders Rights Plan filed on Form 8-K November 21, 1997.

Pacific Gateway Exchange, Inc.

Schedule II

Valuation and Qualifying Accounts

Description	Balance at Beginning of Period	Additions Charged to Costs and Expenses	Deductions-Accounts written off	Balance at End of Period
Allowance for doubtful accounts:				
1997	$1,679	$2,173	$1,622	$2,230
1996	824	1,355	500	1,679
1995	137	687	—	824

EXHIBIT 21.1

SUBSIDIARIES OF PACIFIC GATEWAY EXCHANGE, INC.

Name	Jurisdiction of Organization
Pacific Gateway Exchange (U.K.) Limited	United Kingdom
Pacific Gateway Exchange (Cyprus) Limited	Republic of Cyprus
Pacific Gateway Exchange New Zealand Limited	New Zealand
Pacific Gateway Exchange (Bermuda) Limited	Islands of Bermuda
Rustelnet, a Closed Joint Stock Company	Russian Federation

EXHIBIT 4

MANAGERIAL QUALIFICATIONS

INTERNATIONAL EXCHANGE COMMUNICATIONS, INC. d/b/a IE COM
and
PACIFIC GATEWAY EXCHANGE, INC.

Key Members of Management

Mr. Howard A. Neckowitz has served as President and Director of International Exchange Communications, Inc. d/b/a IE Com ("IE Com") since its inception in June 1997. He has also served as President, Chief Executive Officer and Chairman of the Board of Pacific Gateway Exchange ("PGE") since its inception in August 1991. Mr. Neckowitz previously served as a consultant to major U.S. and overseas telecommunications companies with respect to valuation and due diligence processes for the acquisition of ongoing foreign telecommunications operations and the start up of competitive carrier operations for international, long distance, local and cellular operations in various countries. Prior to his consulting experience, Mr. Neckowitz served from 1982 to 1986 as Director, International Services, at GTE Sprint, where he founded and developed GTE Sprint's international services operation. In this position, he was responsible for feasibility analyses supporting GTE Sprint's entrance into the international switched service market. From 1977 to 1982, Mr. Neckowitz worked at AT&T in its Overseas Department. Mr. Neckowitz serves as Chairman of the Board of Matrix Telecom, Inc., and as a director of Cam-Net Telecommunications, Inc., a provider of domestic telecommunication services in Canada, both of which are customers of PGE.

Ms. Gail E. Granton has served as Vice-President, Secretary and Treasurer of IE Com since its inception in June 1997. Ms. Granton has also served as Executive Vice President, International Business Development, Secretary and a member of the Board of Directors of PGE since its inception in August 1991. From August 1991 to August 1996, she served as Chief Financial Officer of the Company. From 1986 to August 1991, Ms. Granton served as a consultant to major U.S. and overseas telecommunications companies, focusing on the valuation and due diligence process for the acquisition of ongoing foreign telecommunication operations and the start-up of competitive carrier operations for international, long distance, local and cellular operations in various countries. From 1982 to 1986, Ms. Granton worked in the International Department of GTE Sprint, as a Manager, International Business Development, reporting to Mr. Neckowitz.

Ms. Sandra D. Grey has served as Chief Financial Officer of PGE since 1996. From 1989 to 1996, Ms. Grey worked for Telecom New Zealand, the primary provider of telecommunications services in New Zealand, where she was Chief Financial Officer of the International subsidiary. Ms. Grey has more than seven years experience in international telecommunications.

Mr. Ronald D. Anderson has served as Senior Vice President, Operations and Engineering of PGE since December 1992. From 1986 to 1992, Mr. Anderson served in a similar position with TRT International, Inc., an international telecommunications carrier that has since been acquired by WorldCom. Mr. Anderson has more than 15 years of experience in domestic and international telecommunications engineering and operations, with significant experience in international signaling and transmission for cable and satellite, PTT technical interface, and bilateral technical negotiations.

Mr. Robert F. Craver has served as Senior Vice President, International Relations of PGE since February 1994. Prior to joining the Company, Mr. Craver worked at GTE Hawaiian Telephone

Co., Inc. from 1987 to 1994. While at GTE Hawaiian Telephone, Mr. Craver directed that company's international program as Director of International Services. Mr. Craver has also held international positions at Sprint and AT&T, for a total of more than 20 years of experience in the international telecommunications industry. Mr. Craver has extensive experience in international negotiations with foreign partners and has served as an officer of the Pacific Telecommunications Council.

Mr. Fred A. Weismiller joined the Company in November 1994 as Executive Vice President, International Marketing. Mr. Weismiller's responsibilities include developing the value-added long distance services which can be sold to U.S. carriers and to carriers in developing overseas markets. From 1991 to 1994, Mr. Weismiller served as Managing Director and Executive Director, Sales and Marketing at Telecom New Zealand. Mr. Weismiller has 25 years of experience in international and domestic telecommunications management, including 20 years with AT&T, where his final assignment was in Hong Kong as the Managing Director of the AT&T Regional Technical Center from 1989 to 1990.

Mr. William R. Haner has served as Vice President, International Sales, of PGE since January 1995. From 1993 to 1994, Mr. Haner served in a similar position with IDB Communications Group, Inc., an international telecommunications company which has since been acquired by WorldCom. From 1985 to 1993, Mr. Haner was a Director of Sales for TRT International, Inc., where he was responsible for international data services and implementing enhanced facsimile services. Mr. Haner has more than 14 years of sales experience with long distance carriers and commercial customers.

Ms. Joyce R. Hewins joined PGE in December 1993 as Vice President, Carrier Marketing, to develop a U.S. carrier marketing program for the Company. Prior to joining the Company, Ms. Hewins was Director, Carrier Services, at West Coast Communications, where she was responsible for carrier marketing from 1992 to 1993. Ms. Hewins was also Director, Carrier Services at Com System, Inc., a domestic long distance telecommunications company, where she was responsible for developing the carrier marketing program from 1984 to 1992. Ms. Hewins has more than 11 years of experience in the telecommunications industry.

EXHIBIT 5

PROPOSED TARIFF

TITLE SHEET

RESALE TELECOMMUNICATIONS SERVICES

This tariff applies to the resold long distance interexchange telecommunications services furnished by International Exchange Communications, Inc. d/b/a IE Com ("Carrier") between one or more points in the State of Florida. This tariff is on file with the Florida Public Service Commission, and copies may be inspected, during normal business hours, at Carrier's principal place of business, 533 Airport Boulevard, Suite 505, Burlingame, CA 94010.

By:

Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

CHECK SHEET

The sheets of this tariff are effective as of the date shown at the bottom of the respective sheet(s). Original and revised sheets as named below comprise all changes from the original tariff and are currently in effect as of the date on the bottom of this page.

SHEET	REVISION	SHEET	REVISION
1	Original	25	Original
2	Original	26	Original
3	Original	27	Original
4	Original	28	Original
5	Original	29	Original
6	Original	30	Original
7	Original	31	Original
8	Original	32	Original
9	Original	33	Original
10	Original		
11	Original		
12	Original		
13	Original		
14	Original		
15	Original		
16	Original		
17	Original		
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22	Original		
23	Original		
24	Original		

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533 Airport Boulevard, Suite 505
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533 Airport Boulevard, Suite 505
Burlingame, CA 94010

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Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SYMBOLS

The following are the only symbols used for the purposes indicated below:

D - Delete or Discontinue
I - Change Resulting In An Increase to A Customer's Bill
M - Moved From Another Tariff Location
N - New
R - Change Resulting In A Reduction to A Customer's Bill
T - Change In Text or Regulation But No Change In Rate or Charge

By:
Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

TARIFF FORMAT

A. Sheet Numbering - Sheet numbers appear in the upper right corner of the page. Sheets are numbered sequentially. However, new sheets are occasionally added to the tariff. When a new sheet is added between sheets already in effect, a decimal is added. For example, a new sheet added between sheets 14 and 15 would be 14.1.

B. Sheet Revision Numbers - Revision numbers also appear in the upper right corner of each page. These numbers are used to determine the most current sheet version on file with the Commission. For example, the 4th Revised Sheet 14 cancels the 3rd Revised Sheet 14. Because of various suspension periods, deferrals, etc. the Commission follows in their tariff approval process, the most current sheet number on file with the Commission is not always the tariff page in effect.

C. Paragraph Numbering Sequence - There are nine levels of paragraph coding. Each level of coding is subservient to its next higher level:

2.
2.1.
2.1.1.
2.1.1.A.
2.1.1.A.1.
2.1.1.A.1.(a).
2.1.1.A.1.(a).I.
2.1.1.A.1.(a).I.(i).
2.1.1.A.1.(a).I.(i).(1).

D. Check Sheets - When a tariff filing is made with the Commission, an updated check sheet accompanies the tariff filing. The check sheet lists the sheets contained in the tariff, with a cross reference to the current revision number. When new pages are added, the check sheet is changed to reflect the revision. All revisions made in a given filing are designated by an asterisk (*). There will be no other symbols used on the check sheet if these are the only changes made to it (i.e., the format, etc. remains the same, just revised revision levels on some pages). The tariff user should refer to the latest check sheet to find out if a particular sheet is the most current on file with the Commission.

By:

Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 1. TECHNICAL TERMS AND ABBREVIATIONS

Access Line - An arrangement from a local exchange telephone company or other common carrier, using either dedicated or switched access, which connects a Subscriber's location to Carrier's location or switching center.

Authorization Code - A numerical code, one or more of which may be assigned to a Subscriber, to enable Carrier to identify the origin of service User so it may rate and bill the call. All authorization codes shall be the sole property of Carrier and no Subscriber shall have any property or other right or interest in the use of any particular authorization code. Automatic numbering identification (ANI) may be used as or in connection with the authorization code.

Automatic Numbering Identification (ANI) - A type of signaling provided by a local exchange telephone company which automatically identifies the local exchange line from which a call originates.

Calling Card - A postpaid or prepaid calling card issued by Carrier which allows Subscribers and/or Users to make telephone calls and charge the calls to a postpaid or prepaid account. Calls charged to a Carrier-issued postpaid Calling Card will appear on the Subscriber's regular monthly bill. Calls charged to a Carrier-issued prepaid Calling Card will be charged against the debit account.

Carrier or Company - Refers to International Exchange Communications, Inc. d/b/a IE Com

Commission - Refers to the Florida Public Service Commission.

Common Carrier - A company or entity providing telecommunications services to the public.

Complaint - Any oral or written report from a Subscriber or user of telephone service relating to a physical defect, difficulty or dissatisfaction with the operation of telephone facilities, errors in billing or the quality of service rendered.

Day - From 8:00 AM up to but not including 5:00 PM local time Sunday through Friday.

Evening - From 5:00 PM up to but not including 11:00 local time Sunday through Friday.

By:
Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 1. TECHNICAL TERMS AND ABBREVIATIONS (Cont'd)

Holiday - New Year's Day, Memorial Day, Independence Day, Labor Day, Thanksgiving Day and Christmas Day.

Local Access and Transport Area (LATA) - The term "Local Access Transport Area" denotes a geographical area established by the U.S. District Court for the District of Columbia in Civil Action No. 82-0192, within which a local exchange company provides communications services.

Measured Charge - A charge assessed on a per minute basis in calculating a portion of the charges due for a completed interexchange call.

Night/Weekend - From 11:00 PM up to but not including 8:00 AM Sunday through Friday, and 8:00 Am Saturday up to but not including 5:00 PM Sunday.

Subscriber/Customer - The person, firm, corporation or legal entity which enters into arrangements for Carrier's telecommunications services and is responsible for payment of Carrier's services.

Telecommunications - The transmission of voice communications or, subject to the transmission capabilities of the service, the transmission of data, facsimile, signaling, metering, or other similar communications.

User - The person(s) utilizing Carrier's services.

Working Day - Any day on which Carrier is open for business and U.S. Mail is delivered.

SECTION 2. RULES AND REGULATIONS

2 1 Undertaking of the Carrier

2.1 IE Com's services and facilities are furnished for communications originating at specified points within the state of Florida under terms of this tariff.

IE Com installs operates, and maintains the communications services provided herein in accordance with the terms and conditions set forth under this tariff. It may act as the customer's agent for ordering access connection facilities provided by other carriers or entities when authorized by the customer, to allow connection of a customer's location to the Company's network. The customer shall be responsible for all charges due for such service arrangement.

IE Com's services and facilities are provided on a monthly basis unless ordered on a longer term basis, and are available twenty-four hours per day, seven days per week.

The selling of intrastate interexchange ("IXC") telecommunications service to uncertificated IXC resellers is prohibited.

By: Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.3 Liability of Carrier

2.3.1 Except as otherwise stated in this section, the liability of Carrier for damages arising out of either: (1) the furnishing of its services, including but not limited to mistakes, omissions, interruptions, delays, or errors, or other defects, representations, or use of these services, or (2) the failure to furnish its service, whether caused by acts or omission, shall be limited to the extension of allowances to the Customer for interruptions in service as set forth in Section 2.5.

2.3.2 Except for the extension of allowances to the Customer for interruptions in service as set forth in Section 2.5, Carrier shall not be liable to a Customer or third party for any direct, indirect, special, incidental, reliance, consequential, exemplary or punitive damages, including, but not limited to, loss of revenue or profits, for any reason whatsoever, including, but not limited to, any act or omission, failure to perform, delay, interruption, failure to provide any service or any failure in or breakdown of facilities associated with the service.

2.3.3 The liability of Carrier for errors in billing that result in overpayment by the Customer shall be limited to a credit equal to the dollar amount erroneously billed or, in the event that payment has been made and service has been discontinued, to a refund of the amount erroneously billed.

2.3.4 Carrier shall not be liable for any claims for loss or damages involving:

A. Any act or omission of: (1) the Customer, (2) any other entity furnishing service, equipment or facilities for use in conjunction with services or facilities provided by Carrier; or (3) common carriers or warehousemen;

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.3 Liability of Carrier (Cont'd)

2.3.4 (Cont'd)

B. Any delay or failure of performance or equipment due to causes beyond Carrier's control, including but not limited to, acts of God, fires, floods, earthquakes, hurricanes, or other catastrophes; national emergencies, insurrections, riots, wars or other civil commotions; strikes, lockouts, work stoppages or other labor difficulties; criminal actions taken against Carrier; unavailability, failure or malfunction of equipment or facilities provided by the Customer or third parties; and any law, order, regulation or other action of any governing authority or agency thereof;

C. Any unlawful or unauthorized use of Carrier's facilities and services;

D. Libel, slander, invasion of privacy or infringement of patents, trade secrets, or copyrights arising from or in connection with the transmission of communications by means of Carrier-provided facilities or services; or by means of the combination of Carrier-provided facilities or services with Customer-provided facilities or services;

E. Breach in the privacy or security of communications transmitted over Carrier's facilities;

F. Changes in any of the facilities, operations or procedures of Carrier that render any equipment, facilities or services provided by the Customer obsolete, or require modification or alteration of such equipment, facilities or services, or otherwise affect their use or performance, except where reasonable notice is required by Carrier and is not provided to the Customer, in which event Carrier's liability is limited as set forth in subsection 2.3.1 of this Section 2.3.

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.3 Liability of Carrier (Cont'd)

2.3.4 (Cont'd)

G. Injury to property or injury or death to persons, including claims for payments made under Workers' Compensation law or under any plan for employee disability or death benefits, arising out of, or caused by, any act or omission of the Customer, or the construction, installation, maintenance, presence, use or removal of the Customer's facilities or equipment connected, or to be connected to Carrier's facilities;

H. Any intentional, wrongful act of a Carrier employee when such act is not within the scope of the employee's responsibilities for Carrier and/or is not authorized by Carrier;

I. Any representations made by Carrier employees that do not comport, or that are inconsistent, with the provisions of this Tariff;

J. Any act or omission in connection with the provision of 911, E911, or similar services involving emergencies;

K. Any noncompletion of calls due to network busy conditions;

L. Any calls not actually attempted to be completed during any period that service is unavailable.

By: Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.3 Liability of Carrier (Cont'd)

2.3.5 Carrier shall be indemnified, defended and held harmless by the Customer or end user from and against any and all claims, loss, demands, suits, expense, or other action or any liability whatsoever, including attorney fees, whether suffered, made, instituted, or asserted by the Customer or by any other party, for any personal injury to or death of any person or persons, and for any loss, damage or destruction of any property, including environmental contamination, whether owned by the Customer or by any other party, caused or claimed to have been caused directly or indirectly by the installation, operation, failure to operate, maintenance, presence, condition, location, use or removal of any Carrier or Customer equipment or facilities or service provided by Carrier.

2.3.6 Carrier does not guarantee nor make any warranty with respect to installations provided by it for use in an explosive atmosphere. Except as otherwise provided for by applicable law or regulations or determined by a court of competent jurisdiction and unless due to Carrier's negligence, Carrier shall be indemnified, defended and held harmless by the Customer from and against any and all claims, loss, demands, suits, or other action, or any liability whatsoever, including attorney fees, whether suffered, made, instituted or asserted by the Customer or by any other party, for any personal injury to or death of any person or persons, and for any loss, damage or destruction of any property, including environmental contamination, whether owned by the Customer or by any other party, caused or claimed to have been caused directly or indirectly by the installation, operation, failure to operate, maintenance, presence, condition, location, use or removal of any equipment or facilities or the service.

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.3 Liability of Carrier (Cont'd)

2.3.7 Carrier assumes no responsibility for the availability or performance of any cable or satellite systems or related facilities under the control of other entities, or for other facilities provided by other entities used for service to the Customer, even if Carrier has acted as the Customer's agent in arranging for such facilities or services. Such facilities are provided subject to such degree of protection or nonpreemptibility as may be provided by the other entities.

2.3.8 Any claim of whatever nature against Carrier shall be deemed conclusively to have been waived unless presented in writing to Carrier within 180 days after the date of the occurrence that gave rise to the claim.

2.4 Interruption of Service

2.4.1 Credit allowance for the interruption of service which is not due to The Company's testing or adjusting, negligence or the customer, or to the failure of channels or equipment provided by the customer, are subject to the general liability provisions set forth in 2.3.1 herein. It shall be the customer's obligation to notify the Company immediately of any service interruption for which a credit allowance is desired. Before giving such notice, the customer shall ascertain that the trouble is not being caused by any action or omission by the customer within his control, if any, furnished by the customer and connected to the Company's facilities. No refund or credit will be made for the time that the Company stands ready to repair the service and the subscriber does not provide access to the Company for such restoration work.

2.4.2 No credit shall be allowed for an interruption of a continuous duration of less than twenty-four hours after the subscriber notifies the Company.

By:

Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.4 Interruption of Service (Cont'd)

2.4.3 The customer shall be credited for an interruption of more than twenty-four hours as follows:

Credit Formula:

Credit = A/B x C
"A" - outage time in hours
"B" - total hours in a month (month = 720)
"C" - total monthly charge for affected facility

By:

Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.5 Disconnection of Service by Carrier

Carrier, upon 5 working days written notice to the Customer, may discontinue service or cancel an application for service without incurring any liability for any of the following reasons:

2.5.1 Non-payment of any sum due to Carrier for regulated service for more than thirty days beyond the date of rendition of the bill for such service.

2.5.2 A violation of any regulation governing the service under this tariff.

2.5.3 A violation of any law, rule, or regulation of any government authority having jurisdiction over such service.

2.5.4 The Company has given the Customer notice and has allowed a reasonable time to comply with any rule, or remedy, and deficiency as stated in Rule 25-4.113, F.A.C., Refusal or Discontinuance of Service by Company.

2.6 Deposits

The Company does not require a deposit from the Customer.

2.7 Advance Payments

For Customers whom the Company feels an advance payment is necessary, the Company reserves the right to collect an amount not to exceed one (1) month's estimated charges as an advance payment for service. This will be applied against the next month's charges and if necessary a new advance payment will be collected for the next month.

SECTION 2. RULES AND REGULATIONS (Cont'd)

2.10 Minimum Use Contracts(Cont'd)

2.10.3 The initial contract period for service under this section is one month. Subsequent contract periods shall be for additional one-month periods unless otherwise specified.

2.11 Individual Contracts

At the option of the Company, service may be offered on a contract basis to meet specialized requirements of the Customer not contemplated in this tariff as approved by the Florida Public Service Commission. The terms of each contract shall be mutually agreed upon between the Customer and Company and may include discounts off of rates contained herein, waiver of recurring or nonrecurring charges, charges for specially designed and constructed services not contained in the Company's general service offerings, or other customized features. The terms of the contract may be based partially or completely on the term and volume commitment, type of originating or terminating access, mixture of services or other distinguishing features. Service shall be available to all similarly situated Customers for a fixed period of time following the initial offering for the first contract Customer as specific in each individual contract.

SECTION 3. DESCRIPTION OF SERVICES

The regulations set forth in this section explain how to apply the rate tables associated with the various service offerings described in Section 4, following.

3.1 When Billing Charges Begin and End for Phone Calls

The Customer's long distance usage charge is based on the actual usage of the Company's network. Usage begins when the called party picks up the receiver, (i.e. when 2-way communications, often referred to as "conversation time" is possible.). When the called party picks up is determined by hardware answer supervision in which the local telephone company sends a signal to the switch or the software utilizing audio tone detection. When software answer supervision is employed, up to 60 seconds of ringing is allowed before it is billed as usage of the network. A call is terminated when the calling or called party hangs up.

3.2 Billing Increments

The minimum call duration for billing purposes is thirty seconds fo, a connected call and calls beyond thirty seconds are billed in six second increments.

3.3. Uncompleted Calls

The Company does not bill customers for calls which are not completed (busy numbers, no answer, etc.).

3.4. Credit and Refunds

If a credit is requested on a call due to trouble on the line (such as bad connection, disconnection, wrong number dialed, etc.), and the credit is requested immediately through the operator of the underlying carrier, it is issued promptly. All other credit requests are handled through the Company's business office.

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.5 Calculation of Distance

Usage charges for all mileage sensitive products are based on the airline distance between rate centers associated with the originating and terminating points of the call.

The airline mileage between rate centers is determined by applying the formula below to the vertical and horizontal coordinates associated with the rate centers involved. The Company uses the rate centers that are produced by Bell Communications Research in the NPA-NXX V & H Coordinates Tape and Bell's NECA Tariff No. 4.

FORMULA:

The square root of:

$$\frac{(V1 - V2)^2 + (H1 - H2)^2}{10}$$

3.6 Minimum Call Completion Rate

A customer can expect a call completion rate (number of calls completed / number of calls attempted) of not less than 90% during peak use periods.

By: Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings

3.7.1 Prepaid Calling Card - "Travel Express"

Prepaid Calling Card - "Travel Express", (non-operator assisted, direct-dial) is offered to Customers who purchase a prepaid calling card from Carrier. This product is offered to Customers through agents who have contracted with Carrier to market this service to said customers. Cards will be issued in denominations of $10, $20, $30, $50 and $100.

Calls are subject to a one (1) minute minimum billing duration, and sixty (60) second billing increments. Unless where otherwise specified herein, when the application of the rates set forth in this Section results in a fractional charge for an individual call, the total charge for that particular call will be rounded up to the next higher cent. Calls are rated based on call duration, as measured from answer supervision to disconnect. No charge will generally apply to uncompleted calls, which include "ring busy" and "ring no answer" calls. All rates will be per minute of usage, twenty-four (24) hours per day, and seven (7) days per week, 365 days per year. The charge is deducted from the remaining balance on the card after disconnect. The Customer is notified by a beep when one (1) minute of usage remains on the card, if the card is in use.

For intrastate interLATA and intraLATA calls, Customers access the Prepaid Calling Card service by:

1. Dialing 1 + Toll Free Number (800/888) - as indicated on reverse of card.
2. At voice prompt, entering the Card Number.
3. At voice prompt, entering desired destination number by dialing 1 + (Area Code ([NPA]) + (Exchange [NXX]) + (Station [XXXX]).
4. Calls are routed over Carrier's transmission and switching facilities to any valid domestic location served by Carrier.
5. Customer is notified of the dollar value and the number of domestic minutes of usage remaining on the card.

By:

Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings(Cont'd)

3.7.2 SNAP Service[sm]

SNAP Service[sm] (non-operator assisted, direct-dial) is offered to customers, including but not limited to, residential and business Customers.

Calls are subject to a one (1) minute minimum billing duration, and sixty (60) second billing increments. Calls are rated based on call duration, as measured from answer supervision to disconnect. No charge will generally apply to uncompleted calls, which include "ring busy" and "ring no answer" calls, and such uncompleted calls will not knowingly be charged to the Customer and, if charged in error, will be refundable to the Customer. Unless where otherwise specified herein, when the application of the rates set forth in this Section results in a fractional charge for an individual call, the total charge for that particular call will be rounded up to the next higher cent.

All calls and charges covered by this product description will be rendered to the customer by the Local Exchange Company (LEC) on behalf of Carrier by its billing agent.

By: Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings(Cont'd)

3.7.3 Postpaid Calling Card - "Travel Express"

Carrier offers Postpaid Calling Card - "Travel Express," (non-operator assisted, direct-dial) to customers who select Carrier as their long distance carrier and request a calling card on the letter of Authorization (LOA) submitted to Carrier for activation. This product is offered to Customers through agents who have contracted with Carrier to market this service to said Customers.

Calls are subject to a one (1) minute minimum billing duration, and sixty (60) second billing increments. Calls are rated based on call duration, as measured from answer supervision to disconnect. No charge will generally apply to uncompleted calls, which include "ring busy" and "ring no answer" calls.

Customers access Postpaid Calling Card by:

1. Dialing 1+ toll free number (800/888) - as indicated on reverse of card.

2. At voice prompt, entering card number.

3. At voice prompt, entering desired destination number by dialing It (Area Code ([NPA]) + (Exchange [NXX]) + (Station [XXXX]).

4. Calls are routed over Carrier's transmission and switching facilities to any valid domestic location served by Carrier.

The charges for usage on this card will be billed on the customer's Local Exchange Company. (LEC) bill using the customer's billing telephone number.

All rates will be per minute of usage, twenty-four (24) hours per day, and seven days per week, 365 days per year.

By: Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings(Cont'd)

3.7.4 International Program - Residential/Retail[sm]

International Program (IP) - Residential/Retail[sm] (non-operator assisted, direct-dial) is offered to Customers who have a residential line(s) at their premise and are presubscribed to Carrier. The Customer must select the IP - Residential/Retail[sm] product on the Carrier Letter of Agency (LOA).

Calls are subject to a one (1) minute minimum billing duration, and sixty (60) second billing increments. Calls are rated based on call duration, as measured from answer supervision to disconnect. No charge will generally apply to uncompleted calls, which include "ring busy" and "ring no answer" calls, and such uncompleted calls will not knowingly be charged to the Customer and, if charged in error, will be refundable to the Customer. Unless where otherwise specified herein, when the application of the rates set forth in this Section results in a fractional charge for an individual call, the total charge for that particular call will be rounded up to the next higher cent.

For intrastate interLATA and intraLATA calls, Customers access IP - Residential/Retail[sm] by dialing 1 + (Area Code [where required]) + (Exchange [NXX]) + (Station [XXXX]). Calls are routed over Carrier's transmission and switching facilities to any valid domestic location served by Carrier

All calls and charges covered by this product description will be rendered to the customer by the Local Exchange Company (LEC) on behalf of Carrier by its billing agent.

By:

Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings(Cont'd)

3.7.5 International Program - Commercial (Dedicated)[sm]

International Program (IP) - Commercial (Dedicated)[sm], (non-operator assisted, direct-dial) is offered to Customers who have provisioned a dedicated access, private line between their premise and a Carrier point of presence (POP). The Customer must select the IP - Commercial (Dedicated)[sm] product on the Carrier letter of agency (LOA).

Calls are subject to a thirty (30) second minimum billing duration, and six (6) second billing increments. Calls are rated based on call duration, as measured from answer supervision to disconnect. No charge will generally apply to uncompleted calls, which include "ring busy" and "ring no answer" calls, and such uncompleted calls will not knowingly be charged to the Customer and, if charged in error, will be refundable to the Customer.

For intrastate interLATA and intraLATA calls, Customers access IP - Commercial (Dedicated)[sm] by their switch (PBX) outpulsing (dialing) the (Area Code [where required]) + (Exchange [NXX]) + (Station [XXXX]). Calls are routed over Carrier's transmission and switching facilities to any valid domestic location served by Carrier.

All calls and charges covered herein will be rendered to the Customer by Carrier directly. All rates are F.O.B. at the nearest Carrier point of presence to the Customer. From time to time, Carrier will publish a list of its points of presence in the United States.

This dedicated access service will be contracted with Carrier and subject to a six month term contract. Additionally, the customer will be required to invoice a minimum of $3,000 per month or 50,000 billable minutes of traffic to all destinations. This provision will be waived for the first two months of the term period.

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings(Cont'd)

3.7.6 International Program - Commercial (1+)[sm]

International Program (IP) - Commercial (1+)[sm] (non-operator assisted, direct-dial) is offered to customers who have a business line(s) at their premise and are presubscribed to Carrier. The customer must select the IP - Commercial (1+)[sm] product on the Carrier letter of agency (LOA).

Calls are subject to a thirty (30) second minimum billing duration, and six (6) second billing increments. Calls are rated based on call duration, as measured from answer supervision to disconnect. No charge will generally apply to uncompleted calls, which include "ring busy" and "ring no answer" calls, and such uncompleted calls will not knowingly be charged to the Customer and, if charged in error, will be refundable to the Customer.

For intrastate interLATA and intraLATA calls, Customers access IP - Commercial (1+)[sm] by dialing 1 + (Area Code [where required]) + (Exchange [NXX]) + (Station [XXXX]). Calls are routed over Carrier's transmission and switching facilities to any valid domestic location served by Carrier.

At the customer's option, all calls and charges covered by this product description can be rendered to the customer by :

(i) the Local Exchange Company (LEC) on behalf of Carrier by its billing agent; or
(ii) Carrier directly.

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings(Cont'd)

3.7.7 1+ Square Deal[sm]

1+ Square Deal[sm],(non-operator assisted, direct-dial) is offered to customers who have a residential line(s) at their premise and are presubscribed to Carrier. The Customer must select the 1+ Square Deal[sm] product on the Carrier's letter of agency (LOA) or select Carrier as their long distance carrier with their Local Exchange Company (LEC).

Calls are subject to a one (1) minimum billing duration, aud sixty (60) second billing increments. Calls are rated based on call duration, as measured from answer supervision to disconnect. No charge will generally apply to uncompleted calls, which include "ring busy" and "ring no answer" calls, and such uncompleted calls will not knowingly be charged to the Customer and, if charged in error, will be refundable to the Customer.

Customers access 1+Square Deal by dialing 1+ (Area Code [where required])+ (Exchange [NXX])+ (Station [XXXX]). Calls are routed over Carrier's transmission and switching facilities to any valid domestic location served by Carrier.

All calls and charges covered by this product will be rendered to the customer by the Local Exchange Company (LEC) on behalf of Carrier by its billing agent.

Carrier reserves the right to apply all credit policies and procedures in effect at the time of the customer's order for service prior to processing of said order. Carrier additionally reserves the right to discontinue providing service to a customer if in Carrier's sole discretion it believes that the service is being fraudulently to improperly used.

By: Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 3. DESCRIPTION OF SERVICES (Cont'd)

3.7 Service Offerings(Cont'd)

3.7.8 Toll Free Service

Toll Free Service is an inbound-only service that allows callers located in the United States to place toll-free calls by dialing a telephone number in the 800,888 or other toll free area code. Calls may be terminated either to the Customer's local exchange telephone service, or to a dedicated access line. Call charges are billed to the Customer rather than to the originating caller.

By:

Gail E. Granton, Vice President
International Exchange Communications, Inc. d/b/a IE Comm
533 Airport Boulevard, Suite 505
Burlingame, CA 94010

SECTION 4. RATES

4.1 Prepaid Calling Card - "Travel Express"

Per Minute Charge: $0.30

4.2 SNAP Service[sm]

Per Minute Charge: $0.10

4.3 Postpaid Calling Card - "Travel Express"

Per Minute Charge: $0.12

Per Call Surcharge:* $0.75

* Surcharge applies in addition to the per minute usage rate.

4.4 International Program - Residential/Retail[sm]

Per Minute Charge: $0.12

4.5 International Program - Commercial (Dedicated)[sm]

Per Minute Charge: $0.08

4.6 International Program - Commercial (1+)[sm]

Per Minute Charge: $0.11

4.7 1+ Square Deal[sm]

4.7.1 Measured Rates

All rates will be per minute of usage, twenty-four (24) hours per day, and seven (7) days per week, 365 days per year.

Peak hours are Monday through Friday, 7 a.m. to 7 p.m.

SECTION 4. RATES(Cont'd)

4.7 1+ Square Deal℠(Cont'd)

	Peak	Off-Peak
Per Minute Charge	$0.22	$0.10

Unless where otherwise specified herein, when the application of the rates set forth in this Section results in a fractional charge for an individual call, the total charge for that particular call will be rounded up to the next higher cent.

4.8. Toll Free Service

Per Minute Charge: $0.12

4.9 Payment of Calls

4.9.1 Late Payment Charges

Interest charges of 1.5% per month will be assessed on all unpaid balances more than thirty days old.

4.9.2 Return Check Charges

A return check charge of $25.00 will be assessed for checks returned for insufficient funds if the face value does not exceed $50.00, $30.00 if the face value does exceed $50.00 but does not exceed $300.00, $40.00 if the face value exceeds $300.00 or 5% of the value of the check, which ever is greater.

4.10 Restoration of Service

A reconnection fee of $25.00 per occurrence is charged when service is re-established for customers who had been disconnected for non-payment.