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ORIGINAL

July 6, 1999
Overnight

210 N. Park Ave.
Winter Park, FL
32789

P.O. Drawer 200
Winter Park, FL
32790-0200

Tel: 407-740-8575
Fax: 407-740-0613
tmi@tminc.com

Mr. Walter D'Haeseleer
Director of Communications
Florida Public Service Commission
2450 Shumard Oak Boulevard
Gerald L. Gunter Building, Room 270
Tallahassee, FL 32399-0850

990883-TX

RE: Initial Alternative Local Exchange Carrier Application of Allegiance Telecom of Florida

Dear Mr. D'Haeseleer:

Enclosed for filing are the original and six copies of the above referenced application of Allegiance Telecom of Florida.

Also enclosed is a check in the amount of $250 for the filing fee. Questions pertaining to this application should be directed to my attention at (407) 740-8575.

Please acknowledge receipt of this filing by returning, file-stamped, the extra copy of this cover letter in the self-addressed, stamped envelope enclosed for this purpose.

Thank you for your assistance.

Sincerely,

Carey Roesel
Consultant to Allegiance Telecom of Florida

Enclosures

cc: Robert W. McCausland - Allegiance
File: Allegiance - FL ALEC

Check received with filing and forwarded to Fiscal for deposit. ... forward a copy of check ... proof of deposit.

Initials of person who forwarded check:

DOCUMENT NUMBER-DATE
08119 JUL-7 99
FPSC-RECORDS/REPORTING

FLORIDA PUBLIC SERVICE COMMISSION
Division of Communications, Certification & Compliance Section
2450 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850
(850) 413-6600

APPLICATION FORM

for

AUTHORITY TO PROVIDE ALTERNATIVE LOCAL EXCHANGE SERVICE WITHIN THE STATE OF FLORIDA

INSTRUCTIONS

1. This form is used for an original application for a certificate and for approval of sale, assignment, or transfer of an existing alternative local exchange certificate. In case of a sale, assignment or transfer, the information provided shall be for the purchaser, assignee or transferee.

2. Respond to each item requested in the application and appendices. If an item is not applicable, please explain why.

3. Use a separate sheet for each answer which will not fit the allotted space.

4. Any questions regarding completion, contact above.

5. Once completed, submit the original and six (6) copies of this form along with a non-refundable application fee of $250 made payable to the Florida Public Service Commission at the above address.

APPLICATION FORM FOR AUTHORITY TO PROVIDE ALTERNATIVE LOCAL EXCHANGE SERVICE WITHIN THE STATE OF FLORIDA

1. **This is an application for (check one):**

   (X) Original authority (new company)

   ( ) Approval of transfer (to another certificated company)
   Example: a certificated company purchases an existing company and desires to retain the original certificate authority.

   ( ) Approval of assignment of existing certificate (to a noncertificated company)
   Example: a non-certificated company purchases an existing company and desires to retain the certificate of authority rather than apply for a new certificate.

   ( ) Approval for transfer of control (to another certificated company)
   Example: a company purchases 51% of a certificated company. The Commission must approve the new controlling entity.

2. **Name of applicant:**

   Allegiance Telecom of Florida, Inc.

3. A. **National Mailing Address including street name, number, post office box, city, state, zip code and phone number.**

Street:	1950 Stemmons Freeway, Suite 3026
PO Box	
City:	Dallas
State:	Texas
Zip	75207-3118
Phone:	(214) 261-7100

   B. **Florida Mailing Address including street name, number, post office box, city, state, zip code and phone number.**

Street:	1950 Stemmons Freeway, Suite 3026
PO Box	
City:	Dallas
State:	Texas
Zip	75207-3118
Phone:	(214) 261-7100

C. **Physical Address of alternative local exchange service in Florida including street name, number, post office box, city, state, zip code and phone number.**

Street:	1950 Stemmons Freeway, Suite 3026
PO Box	
City:	Dallas
State:	Texas
Zip	75207-3118
Phone:	(214) 261-7100

4. **Structure of organization:**

( ) Individual
( ) Foreign Corporation
( ) General Partnership
( ) Joint Venture
(X) Corporation
( ) Foreign Partnership
( ) Limited Partnership
( ) Other

5. **If incorporated, please provide proof from the Florida Secretary of State that the applicant has authority to operate in Florida.**

Corporate charter number: F98000003614
Taxpayer Identification # 75-2726851

Please see Exhibit I for a copy of the Articles of Incorporation.

6. **Name under which the applicant will do business (d/b/a):**

Allegiance Telecom of Florida, Inc.

7. **If applicable, please provide proof of fictitious name: (d/b/a) registration.**

Not applicable

8. **If applicant is an individual, partnership, or joint venture, please give name and address of each legal entity.**

Not applicable

9. **State whether any of the officers, directors, or any of the ten largest stockholders have previously been adjudged bankrupt, mentally incompetent, or found guilty of any felony or of any crime, or whether such actions may result from pending proceedings. If so, please explain.**

No officer, director or any of the ten largest stockholders are known to have previously been adjudged bankrupt, mentally incompetent, or found guilty of any felony or of any crime. Hence, no such action may result from a pending proceeding.

10. Please provide the title, address, telephone number, internet address and facsimile number of the person serving as ongoing liaison with the Commission, and if different, the liaison responsible for this application:

Application contact:

Name:	Carey Roesel
Title:	Consultant
P.O. Box:	P.O. Drawer 200
City:	Winter Park
State:	Florida
Zip:	32790-0200
Phone:	(407) 740-8575
Fax:	(407) 740-0613
Internet Address:	croesel@tminc.com

Ongoing Liaison:

Name:	Robert W. McCausland
Title:	Vice President, Regulatory and Interconnection
Street:	1950 Stemmons Freeway, Suite 3026
PO Box	
City:	Dallas
State:	Texas
Zip	75207-3118
Phone:	(214) 261-7117
Fax:	(214) 261-7110
Internet Address:	robert.mccausland@allegiancetelecom.com

11. Please list other states in which the applicant is currently providing or has applied to provide local exchange or alternative local exchange service.

Allegiance Telecom of Florida is currently only seeking certification in Florida. Allegiance Telecom of Florida's affiliates, however, have obtained certification in California, Colorado, the District of Columbia, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Pennsylvania, Texas, Virginia, and Washington.

12. Has the applicant been denied certification in any other state?

Yes( ) No (X)
If so, please list the state and reason for denial.

13. Have penalties been imposed against the applicant in any other state:

Yes( ) No (X)
If so, please list the state and reason for penalty.

14. Please indicate how a customer can file a service complaint with your company.

Customers may call the Toll-Free Customer Service number, (800) 553-1989, 24 hours a day, seven days a week.

15. Please provide all available documentation demonstrating that the applicant has the following capabilities to provide alternative local exchange service in Florida.

A. Financial capability (Exhibit II)

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 statement should then be signed by the applicant's chief executive officer and chief financial officer. The signature should affirm that the financial statements are true and correct.

B. Managerial capability

See Exhibit III

C. Technical capability

See Exhibit IV

AFFIDAVIT

By my signature below, I, the undersigned officer, attest to the accuracy of the information contained in this application and attached documents and that the applicant has the technical expertise, managerial ability, and financial capability to provide alternative local exchange service in the State of Florida. I have read the foregoing and declare that to the best of my knowledge and belief, the information is true and correct. I attest that I have the authority to sign on behalf of my company and agree to comply, now and in the future, with all applicable Commission rules and orders.

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.

Official: C. Daniel Yost **Date:** 6\28\99

C. Daniel Yost

Title: President and COO

Address: 1950 Stemmons Freeway, Suite 3026

Dallas, Texas 75207-3118

Phone: (214) 261-7100

Subscribed and sworn to before me this 30 day of June, 1999

Carol Galeno

Notary Public

My Commission expires: 2003

ALLEGIANCE TELECOM OF FLORIDA, INC.

EXHIBIT I

ARTICLES OF INCORPORATION

State of Delaware

Office of the Secretary of State

I, EDWARD J. FREEL, SECRETARY OF STATE OF THE STATE OF DELAWARE, DO HEREBY CERTIFY THE ATTACHED IS A TRUE AND CORRECT COPY OF THE CERTIFICATE OF INCORPORATION OF "ALLEGIANCE TELECOM OF FLORIDA, INC.", FILED IN THIS OFFICE ON THE TWENTY-NINTH DAY OF MAY, A.D. 1998, AT 1:30 O'CLOCK P.M.

A FILED COPY OF THIS CERTIFICATE HAS BEEN FORWARDED TO THE NEW CASTLE COUNTY RECORDER OF DEEDS.

Edward J. Freel

Edward J. Freel, Secretary of State

2902289 8100

981206890

AUTHENTICATION: 9109741

DATE: 05-29-98

CERTIFICATE OF INCORPORATION
OF
ALLEGIANCE TELECOM OF FLORIDA, INC.

FIRST: The name of the Corporation is Allegiance Telecom of Florida, Inc.

SECOND: The address of the Corporation's registered office in the State of Delaware is 1209 Orange Street, City of Wilmington, County of New Castle, Delaware 19801. The name of the Corporation's registered agent at such address is The Corporation Trust Company.

THIRD: The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of the State of Delaware.

FOURTH: The total number of shares of all classes that the Corporation shall have authority to issue is 10,000 shares, par value $0.01 per share, to be issued as shares of Common Stock.

FIFTH: Except as otherwise required by law or expressly provided in this Certificate of Incorporation, each share of Common Stock shall entitle the holder thereof to one (1) vote of each matter submitted to a vote of the stockholders.

SIXTH: The stockholders shall have the pre-emptive right to purchase or subscribe to additional shares of unissued stock, or any additional shares of any class of unissued stock, or additional shares of any class to be issued by any increase of the authorized capital stock of the Corporation before such shares are offered to third parties, when and if the board of directors of the Corporation (the "Board of Directors") shall decide that any stock is for sale. In addition, the Corporation shall have the right of first refusal to purchase any shares of common stock offered by a stockholder for sale to a third party.

SEVENTH: The name and mailing address of the incorporator of the Corporation are as follows:

Name	Address
Robert McCausland	1950 Stemmons Freeway Suite 3026 Dallas, Texas 75207

EIGHTH: In furtherance and not in limitation of the powers conferred by statute, the Board of Directors is expressly authorized to make, alter or repeal the By-Laws of the Corporation, subject to any specific limitation on such power provided by any By-Laws adopted by the stockholders.

NINTH: Elections of directors need not be by written ballot unless the By-Laws of the Corporation so provide.

TENTH: The Corporation is to have perpetual existence.

ELEVENTH: The Corporation reserves the right to amend, alter, change or repeal any provision contained in this Certificate of Incorporation, in the manner now or hereafter prescribed by statute, and all rights conferred upon the stockholders herein are granted subject to this reservation.

TWELFTH: A. A director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability (i) for any breach of the director's duty of loyalty to the Corporation or its stockholders, (ii) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (iii) under Section 174 of the General Corporation Law of the State of Delaware, or (iv) for any transaction from which the director derived an improper personal benefit. If the General Corporation Law of the State of Delaware is amended to authorize corporate action further eliminating or limiting the personal liability of directors, then the liability of a director of the Corporation shall be eliminated or limited to the fullest extent permitted by the General Corporation Law of the State of Delaware, as so amended. Any repeal or modification of this Section A by the stockholders of the Corporation shall not adversely affect any right or protection of a director of the Corporation existing at the time of such repeal or modification.

B. Each person who was or is made a party or is threatened to be made a party to or is or was involved in any action, suit, or proceeding, whether civil, criminal, administrative or investigative (hereinafter a "proceeding'), by reason of the fact that he or she or a person of whom he or she is the legal representative is or was a director, officer or employee of the Corporation or is or was serving at the request of the Corporation as a director, officer, employee or agent of another corporation or of a partnership, joint venture, trust or other enterprise, including service with respect to employee benefit plans, whether the basis of such proceeding is alleged action in an official capacity as a director, officer, employee or agent or in any other capacity while serving as a director, officer, employee or agent, shall be indemnified and held harmless by the Corporation to the fullest extent authorized by the General Corporation Law of the State of Delaware as the same exists or may hereafter be amended (but, in the case of any such amendment, only to the extent that such amendment permits the Corporation to provide broader indemnification rights than said law permitted the Corporation to provide prior to such amendment), against all expense, liability and loss (including attorneys' fees, judgments, fines, ERISA excise taxes or penalties and amounts paid or to be paid in settlement) reasonably incurred or suffered by such person in connection therewith and such indemnification shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of his or her heirs, executors and administrators; provided, however, that except as provided in Section C of this Article Twelfth with respect to proceedings seeking to enforce rights to indemnification, the Corporation shall indemnify any such person seeking indemnification in connection with a proceeding (or part thereof) initiated by such person only if such proceeding (or part thereof) was authorized by the Board of Directors . The right to indemnification conferred in this Section B shall be a contract right and shall include the right to be paid by the Corporation the expenses incurred in defending any such proceeding in advance of its final disposition; provided, however, that if the General Corporation Law of the State of Delaware requires, the payment of such expenses incurred by a director or officer in his or her capacity as a director or officer (and not in any other capacity in which service was or is rendered by such person while a director or officer, including without limitation, service to an employee benefit plan) in advance of the final disposition of a proceeding, shall be made only upon delivery to the Corporation of any undertaking by or on behalf of such director or officer, to repay all amounts so advanced if it shall ultimately be determined that such director or officer is not entitled to be indemnified under this Section B or otherwise.

C. If a claim under Section B of this Article Twelfth is not paid in full by the Corporation within thirty days after a written claim has been received by the Corporation, the claimant may at any time thereafter bring suit against the Corporation to recover the unpaid amount of the claim and, if successful in whole or in part, the claimant shall be entitled to be paid also the expense of prosecuting such claim. It shall be a defense to any such action (other than an action brought to enforce a claim for expenses incurred in defending any proceeding in advance of its final disposition where the required undertaking, if any is required, has been tendered to the Corporation) that the claimant has not met the standards of conduct that make it permissible under the General Corporation Law of the State of Delaware for the Corporation to indemnify the claimant for the amount claimed, but the burden of proving such defense shall be on the Corporation. Neither the failure of the Corporation (including its Board of Directors, independent legal counsel or stockholders) to have made a determination prior to the commencement of such action that indemnification of the claimant is proper in the circumstances because he or she has met the applicable standard of conduct set forth in the General Corporation Law of the State of Delaware, nor an actual determination by the Corporation (including its Board of Directors, independent legal counsel or stockholder) that the claimant has not met such applicable standard of conduct, shall be a defense to the action or create a presumption that the claimant has not met the applicable standard of conduct.

D. The right to indemnification and the payment of expenses incurred in defending a proceeding in advance of its final disposition conferred in this Article Twelfth shall not be exclusive of any other right that any person may have or hereafter acquire under any statute, provision of the Certificate of Incorporation, By-Law, agreement, vote of stockholders or disinterested directors or otherwise.

E. The Corporation may purchase and maintain insurance or furnish similar protection, including, but not limited to, providing a trust fund, letter of credit or self-insurance, at its expense, to protect itself and any director, officer, employee or agent of the Corporation or another corporation, partnership, joint venture, trust or other enterprise against any expenses, liability or loss, whether or not the Corporation would have the power to indemnify such person against such expense, liability or loss under the General Corporation Law of the State of Delaware.

F. The Corporation may, to the extent authorized from time to time by the Board of Directors, grant rights to indemnification, and rights to be paid by the Corporation the expenses incurred in defending any proceeding in advance of its final disposition, to any agent of the Corporation to the fullest extent of the provisions of this Article Twelfth with respect to the indemnification and advancement of expenses of directors, officers and employees of the Corporation.

THE UNDERSIGNED, being the incorporator hereinbefore named, for the purpose of forming a corporation pursuant to the General Corporation Law of the State of Delaware, makes this Certificate, hereby declaring and certifying that the facts herein stated are true, and accordingly has hereunto set his hand and seal this 28th day of May, 1998.

Robert McCausland

State of Florida

Department of State

I certify from the records of this office that ALLEGIANCE TELECOM OF FLORIDA, INC., is a corporation organized under the laws of Delaware, authorized to transact business in the State of Florida, qualified on June 24, 1998.

The document number of this corporation is F98000003614.

I further certify that said corporation has paid all fees and penalties due this office through December 31, 1998, and its status is active.

I further certify that said corporation has not filed a Certificate of Withdrawal.

Given under my hand and the
Great Seal of the State of Florida
at Tallahassee, the Capitol, this the
Twenty-sixth day of June, 1998

GREAT SEAL OF THE STATE OF FLORIDA
IN GOD WE TRUST

Sandra B. Mortham

Sandra B. Mortham
Secretary of State

CR2EO22 (2-95)

ALLEGIANCE TELECOM OF FLORIDA, INC.

EXHIBIT II

FINANCIAL CAPABILITY

ALLEGIANCE TELECOM OF FLORIDA, INC.

Supplemental Financial Information

1. Please provide documentation that the applicant has sufficient financial capability to provide the requested service in the geographic area proposed to be served.

   Allegiance Telecom of Florida, Inc., possesses the financial capability to provide the requested service. In support of its financial viability, Allegiance Telecom of Florida, Inc., submits the 1998 Form 10-K of its parent, Allegiance Telecom, Inc. Allegiance Telecom of Florida is a subsidiary of Allegiance Finance Company, Inc., which is a subsidiary of Allegiance Telecom, Inc.

   This financial information demonstrates that the Company possesses the necessary financial capability.

2. Please provide documentation that the applicant has sufficient financial capability to maintain the requested service.

   Please see response to question #1.

3. Please provide documentation that the applicant has sufficient financial capability to meet its lease or ownership obligations.

   Please see response to question #1.

NOTE: This documentation may include, but is not limited to, financial statements, a projected profit and loss statement, credit references, credit bureau reports, and descriptions of business relationships with financial institutions.

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-K

[X] Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended: December 31, 1998 or

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from ____________ to ____________.

Commission File Number: 0-24509

ALLEGIANCE TELECOM, INC.
(Exact name of registrant as specified in its charter)

Delaware	75-2721491
(State of Incorporation)	(IRS Employer Identification No.)

1950 Stemmons Freeway Suite 3026 Dallas, Texas 75207 (214) 261-7100 (Address of Principal Executive Offices) (Zip Code) (Registrant's Telephone Number, Including Area Code)

Securities Registered Pursuant to Section 12(b) of the Act:	None
Securities Registered Pursuant to Section 12(g) of the Act:	Common Stock, par value $.01, quoted on the Nasdaq National Market

Indicate by check mark whether Allegiance (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 it was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Allegiance'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. [X]

Based on the closing sales price on the Nasdaq National Market on March 24, 1999 of $26.125, the aggregate market value of our voting stock held by non-affiliates on such date was approximately $400,981,896. Shares of common stock held by each director and executive officer and by each person who owns or may be deemed to own 10% or more of our outstanding common stock have been excluded, since such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes. As of that date, Allegiance Telecom, Inc. had 50,360,886 shares of common stock issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

o Portions of Allegiance's annual report to stockholders for fiscal year ended December 31, 1998 are incorporated by reference into Parts II and IV of this report. This annual report shall be deemed "filed" with the SEC only with respect to those portions specifically incorporated by reference in this report.

o Portions of Allegiance's definitive proxy statement for the annual meeting of stockholders for the fiscal year ended December 31, 1998, which will be filed with the SEC no later than April 30, 1999, are incorporated by reference into Part III of this report.

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TO

ALLEGIANCE TELECOM, INC.'S ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDING DECEMBER 31, 1998

RECENT DEVELOPMENTS

On March 19, 1999, we announced that we intend to offer 10,000,000 shares of our common stock in an underwritten primary offering. We also recently retained Goldman Sachs Credit Partners L.P., TD Securities (USA) Inc. and Morgan Stanley Senior Funding, Inc. to arrange a senior secured revolving credit facility maturing December 31, 2005 for a subsidiary of Allegiance Telecom, Inc. These banks have received commitments for this facility aggregating in excess of $200 million from various lenders. These commitments remain subject to various conditions including the negotiation and execution of a definitive credit agreement. Assuming the closing of the common stock offering and of the credit facility, we plan to accelerate deployment of our networks in Detroit and Baltimore into 1999.

Based on preliminary information, we estimate that for the three months ended March 31, 1999, we will have consolidated revenues of $9.7 million and earnings before interest, income taxes, depreciation and amortization, management ownership allocation charge and noncash deferred compensation of negative $25 million; and will have made capital expenditures of approximately $60 million. We believe that for the first quarter of 1999, we will have sold 44,500 lines and that 32,000 lines will have been installed.

PART I

ITEM 1. BUSINESS

OVERVIEW

Allegiance seeks to be a premier provider of telecommunications services to business, government and other institutional users in 24 of the largest major metropolitan areas across the United States. Allegiance offers an integrated set of telecommunications products and services including local exchange, local access, domestic and international long distance, enhanced voice, data and a full suite of Internet services. Allegiance generally prices these services at a discount of 5% to 15% below the prices charged by the incumbent local exchange carriers. Allegiance was founded in April 1997 by a management team led by Royce J. Holland, the former President, Chief Operating Officer and co-founder of MFS Communications, and Thomas M. Lord, former Managing Director of Bear, Stearns

& Co. Inc., where he specialized in the telecommunications, information services and technology industries.

Allegiance believes that the Telecommunications Act, by opening the local exchange market to competition, has created an attractive opportunity for new facilities-based competitive local exchange carriers like Allegiance. Most importantly, the Telecommunications Act stated that these carriers, known as CLECs, should be able to lease the various elements of the ILECs' networks, which are necessary for the cost-effective provision of service. This aspect of the Telecommunications Act, which is referred to as "unbundling" the ILEC networks, has enabled Allegiance to deploy digital switches with local and long distance capability and lease fiber optic lines from the ILECs, other CLECs, and other telecommunications companies to connect Allegiance's switch with its transmission equipment located in ILEC central offices. Once traffic volume growth justifies further capital investment, Allegiance may lease dark fiber or construct its own fiber network.

Allegiance has developed procedures, together with its back office systems vendors, MetaSolv, DSET, Lucent and Intertech, that it believes will provide it with a significant competitive advantage in terms of reducing costs, processing large order volumes and providing customer service. Back office systems enable a phone company to enter, schedule and track a customer's order from the point of sale to the installation and testing of service. These systems also include or interface with trouble management, inventory, billing, collection and customer service systems.

Allegiance is determined to achieve electronic bonding, the on-line and real-time connection of Allegiance's operations support systems with those of the ILECs, with each of the incumbent telecommunications companies in most of its markets by the end of 1999. On January 8, 1999, Allegiance and Bell Atlantic became the first facilities-based CLEC and ILEC to formally engage in electronic bonding after working since April 1998 to develop the necessary software and processes. This will allow Allegiance to create service requests on-line, leading to faster installations of customer orders through a reduction in errors associated with multiple manual inputs. Allegiance expects electronic bonding to improve productivity by decreasing the period between the time of sale and the time a

customer's line is installed in the Allegiance network. In addition, Allegiance expects that the simplified process will reduce selling, general and administrative costs.

Allegiance believes that it will be some time before many other CLECs and telecommunications service companies will be able to implement similar electronic bonding systems. Unlike Allegiance, which is a new company designing its systems specifically for electronic bonding, most of these other carriers have systems that have been in place for years and already support a large number of customers with ongoing service. Updating these systems can therefore disrupt service and be much more costly and time consuming.

Allegiance intends to continue network deployment of its initial 24 markets. Allegiance estimates that these 24 markets will include more than 21 million non-residential access lines. According to Allegiance estimates, this represents approximately 44.7% of the total non-residential access lines in the U.S. With a strategy focusing on the central business districts and suburban commercial districts in these areas, Allegiance plans to address a majority of the non-residential access lines in most of its targeted markets.

As of December 31, 1998, Allegiance was operational in nine markets: New York City, Dallas, Atlanta, Fort Worth, Chicago, Los Angeles, San Francisco, Boston and Oakland. As of such date, Allegiance was in the process of deploying networks in eight other markets: Houston, Long Island, Northern New Jersey, Orange County, San Diego, San Jose, Philadelphia and Washington, D.C.

As of March 15, 1999, Allegiance was operational in eleven markets: New York City, Dallas, Atlanta, Fort Worth, Chicago, Los Angeles, San Francisco, Boston, Oakland, Philadelphia and Washington, D.C. As of such date, Allegiance was in the process of deploying networks in six other markets: Houston, Long Island, Northern New Jersey, Orange County, San Diego and San Jose.

ALLEGIANCE'S TELECOMMUNICATIONS SERVICES

Allegiance tailors its service offerings to meet the specific needs of the business, government, and other institutional customers in its target markets. Management believes that Allegiance's close contact with customers from its direct sales force and customer care personnel will enable it to tailor its service offerings to meet customers' needs and to creatively package its services to provide "one-stop shopping" solutions for those customers.

Local Exchange Services. Allegiance offers local telephone services, including local dial tone as well as other features such as:

- call forwarding;
- call waiting;
- dial back;
- caller ID; and
- voice mail.

By offering dial tone service, Allegiance also receives originating and terminating access charges for interexchange calls placed or received by its subscribers.

Private Branch Exchange/Shared Tenant Services. In areas where telephone density is high and most telephone customers desire similar services, such as office buildings, apartments, condominiums or campus-type environments, a private branch exchange or services such as Centrex are among the most efficient means of providing telephone services. A private branch exchange, also known as "PBX," is a switching system located within an office building and owned by a customer which allows calls from the outside to be routed directly to the individual instead of through a central number. PBX also allows for calling within an office by way of four digit extensions. Centrex is a service that offers features similar to those of a PBX, except that the switching equipment is located at the telephone carrier's premises and not at the customer's premises. The use of the Centrex service eliminates the need for large capital expenditures on a PBX. Allegiance intends to offer these services in areas where market potential warrants.

Integrated Services Digital Network and High Speed Data Services. Allegiance offers high speed data transmission services, such as:

- wide area network interconnection, which are remote computer communications systems that allow file sharing among geographically distributed workgroups; wide area networks typically use links provided by local telephone companies; and
- broadband Internet access, also known as "wideband," which allows large quantities of data to be transmitted simultaneously.

These services may be provided via frame relay and dedicated point-to-point connections. In order to provide these services, Allegiance intends to utilize leased high capacity connections, such as multiple DS-1, DS-3, T1 or T3 connections, to medium- and large-sized business, government and other institutional customers. Allegiance may also employ DSL and/or ISDN connections over unbundled copper wire connections to smaller business users whose telecommunications requirements may not justify such high capacity connections or which are located in areas where T1 connections are not available.

Interexchange/Long Distance Services. Allegiance offers a full range of:

- domestic long distance services, such as:
  - interLATA, which are calls that pass one "Local Access and Transport Area" or "LATA" to another, and such calls must be carried across the LATA boundary by a long-distance carrier,
  - intraLATA, which is a call that falls within the local service area of a single local telephone company, and
- international long distance services.

These services include "1+" outbound calling, inbound toll free service, and such complementary services as calling cards, operator assistance, and conference calling.

Enhanced Internet Services. Allegiance offers dedicated and dial-up high speed Internet access services via conventional modem connections, ISDN, and T1 and higher speed dedicated connections. In addition, Allegiance expects to offer DSL services beginning in 1999. Dedicated access services are telecommunications lines dedicated or reserved for use by particular customers.

Web Site Design and Hosting Services. Allegiance plans to offer Web site design services and Web site hosting on its own computer servers to provide customers with a complete, easy to use key solution that gives them a presence on the World Wide Web.

Facilities and Systems Integration Services. Allegiance offers individual customers assistance with the:

o design and implementation of complete, easy to use solutions in order to meet their specific needs, including the selection of the customer's premises equipment, interconnection of local area networks and wide area networks, and

o implementation of virtual private networks. Virtual private networks simulate private line networks without actually building a private network and offer special services such as abbreviated dialing, where a customer can call between offices in different area codes without having to dial all eleven digits.

Wholesale Services to Internet Service Providers. Allegiance believes that with the recent growth in demand for Internet services, numerous Internet service providers are unable to obtain network capacity rapidly enough to meet customer demand and eliminate network congestion problems. Allegiance plans to supplement its core customer product offerings by providing a full array of local services to Internet service providers, including telephone numbers and switched and dedicated access to the Internet.

SALES AND CUSTOMER SUPPORT

Allegiance offers an integrated package of local exchange, local access, domestic and international long distance, enhanced voice, data, and a full suite of Internet services to small and medium-sized businesses. Unlike large corporate, government, or other institutional users, small and medium-sized businesses often have no in-house telecommunications manager. Based on management's previous experience, Allegiance believes that a direct sales and customer care program focusing on complete, "one-stop shopping" solutions will have a competitive advantage in capturing this type of customer's total telecommunications traffic.

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Although the vast majority of Allegiance's sales force is focused primarily on the small and medium-sized business market, Allegiance also provides services to large business, government, and other institutional users, as well as to Internet service providers, and expects that a significant portion of its initial revenue will come from these areas of its business. Therefore, Allegiance has organized its sales and customer care organizations to serve each of these three markets. Sales and marketing approaches in the telecommunications market are market-segment specific, and Allegiance believes the following are the most effective approaches with respect to its three targeted markets:

o Small/medium businesses -- Allegiance uses direct sales.

o Large business, government, and other institutional users -- Allegiance uses account teams, established business relationships, applications sales and technical journal articles, and is an exhibitor at trade shows.

o Wholesale carriers, primarily Internet service providers -- Allegiance uses direct sales, established business relationships, and competitive pricing.

Allegiance organizes account executives into teams of six to eight persons with a team manager and a sales support specialist. These teams utilize telemarketing to "qualify" leads and set up initial appointments. Allegiance closely manages account executives with regard to the number of sales calls per week, with the goal of eventually calling on every prospective business customer in an account executive's sales territory. Allegiance uses commission plans and incentive programs to reward and retain the top performers and encourage strong customer relationships. The sales team managers for each market report to a city sales vice president who in turn reports to a regional vice president.

Allegiance's wholesale sales to Internet service providers are performed by account executives reporting to the vice president of national accounts. The vice president of national accounts also has responsibility for large corporate, government, and other institutional accounts, with designated national account managers and sales support personnel assigned to the major accounts. Unlike the small and medium-sized business accounts, the national account program is being built by recruiting national account managers with established business relationships with large corporate accounts, supported by technical applications personnel and customer care specialists.

Allegiance has focused its efforts on developing a personalized customer care program. Allegiance's customer service representatives are available seven days a week, 24 hours a day. In addition, Allegiance uses customer care specialists to support its national accounts.

INFORMATION SYSTEMS

Allegiance is continuing to develop its tailored information systems and procedures for operations support and other back office systems that it believes will provide a significant competitive advantage in terms of cost, processing large order volumes, and customer service. These systems are required to enter, schedule, provision, and track a customer's order from the point of sale to the installation and testing of service and also include or interface with trouble management, inventory, billing, collection and customer service systems. The existing systems currently employed by most ILECs, CLECs and long distance carriers, which were developed prior to the passage of the Telecommunications Act, generally require multiple entries of customer information to accomplish order management, provisioning, switch administration and billing. This process is not only labor intensive, but it creates numerous opportunities for errors in provisioning service and billing, delays in installing orders, service interruptions, poor customer service, increased customer turnover, and significant added expenses due to duplicated efforts and decreased customer satisfaction.

Allegiance believes that the practical problems and costs of upgrading existing systems are often prohibitive for companies whose existing systems support a large number of customers with ongoing service. Because Allegiance does not have systems designed prior to the expanded interaction between CLECs and ILECs introduced by the Telecommunications Act, Allegiance's team of engineering and information technology professionals experienced in the CLEC industry is free to develop operations support and other back office systems designed to facilitate a smooth, efficient order management, provisioning, trouble management, billing and collection, and customer care process. See "Risk Factors -- We Are Dependent on Effective Billing, Customer Service and Information Systems and We May Have Difficulties in Developing These Systems."

Order Management. Allegiance is licensing MetaSolv's order management software. This product allows the sales team not only to enter customer orders onsite, via computer and/or over the Internet, but also to monitor the status of the order as it progresses through the service initiation process.

Provisioning Management. The licensed order management software also supports the design and management of the provisioning process, including circuit design and work flow management. The system has been designed to permit programming into the system of a standard schedule of tasks which must be accomplished in order to initiate service to a customer, as well as the standard time intervals during which each such task must be completed. This way, when a standard order is selected in the system, each required task in the service initiation process can be efficiently managed to its assigned time interval.

External Interfaces. Several external interfaces are required to initiate service for a customer. While some of these are automated via gateways from the order management software, the most important interfaces, those to the ILEC, have generally been accomplished via fax or e-mail. In an effort to make this process more efficient, Allegiance and Bell Atlantic announced on January 8, 1999, the first implementation of electronic bonding between the operations support system of a facilities-based CLEC and an ILEC.

Electronic bonding will allow Allegiance to access data from the ILEC, submit service requests electronically, and more quickly attend to errors in the local service request form because an order is bounced back immediately if the ILEC determines that there is a mistake. As a result, Allegiance expects to be able to eventually reduce the time frame required to switch service to Allegiance from approximately 25 business days to as low as five business days, as compared to three days currently required to switch to a new long distance carrier. Electronic bonding should also enable Allegiance to improve its ability to provide better customer care since Allegiance will more readily be able to pinpoint where any problems may have occurred with a customer's order.

Network Element Administration. Allegiance licenses their software for administrating each element of the Allegiance network. Allegiance is currently developing an interface between its order management system and the network element manager to integrate data integrity and eliminate redundant data entry.

Customer Billing. Allegiance has selected a billing services provider which credits the collections made to Allegiance's lock-box. Customer information is electronically interfaced with this provider from Allegiance's order management system via a gateway, thereby integrating all repositories of information. We are continuing to develop other enhancements to the gateway.

Billing Records. Local and intraLATA billing records are generated by the Lucent Series 5ESS(R)-2000 switches to record customer calling activity. InterLATA billing records are generated by the long distance carrier with whom Allegiance has a resale agreement, to record customer calling activity. These records will be automatically processed by the billing services provider in order to calculate and produce bills in a customer-specified billing format.

NETWORK DEPLOYMENT

As of March 15, 1999, Allegiance was operational in eleven markets: New York City, Dallas, Atlanta, Fort Worth, Chicago, Los Angeles, San Francisco, Boston, Oakland, Philadelphia and Washington, D.C. As of such date, Allegiance was in the process of deploying networks in six other markets: Houston, Long Island, Northern New Jersey, Orange County, San Diego, and San Jose.

The following table sets forth the initial markets targeted by Allegiance and the current buildout schedule. The order and timing of network deployment may vary and will depend on a number of factors, including recruiting city management, the regulatory environment, Allegiance's results of operations and the existence of specific market opportunities, such as acquisitions. Allegiance may also elect not to deploy networks in each such market.

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MARKET SIZE AND BUILDOUT SCHEDULE

MARKET	ESTIMATED TOTAL NON-RESIDENTIAL ACCESS LINES (1) (THOUSANDS)	% OF TOTAL U.S. NON-RESIDENTIAL ACCESS LINES (2)	INITIAL FACILITIES-BASED SERVICE DATE (3)
New York City	3,298(4)	6.7%(4)	March 1998
Dallas, TX	867(5)	1.8%(5)	April 1998
Atlanta, GA	612	1.2%	April 1998
Fort Worth, TX	--(5)	-- (5)	July 1998
Chicago, IL	1,951	4.0%	September 1998
Los Angeles, CA	3,430(6)	7.0%(6)	October 1998
San Francisco, CA	2,148(7)	4.4%(7)	November 1998
Boston, MA	649	1.3%	December 1998
Oakland, CA	--(7)	-- (7)	December 1998
Philadelphia, PA	1,754	3.6%	February 1999
Washington, D.C	871	1.8%	March 1999
San Jose, CA	--(7)	-- (7)	1999
Northern New Jersey	--(4)	-- (4)	1999
Houston, TX	765	1.6%	1999
Orange County, CA	--(6)	-- (6)	1999
San Diego, CA	790	1.6%	1999
Long Island, NY	--(4)	-- (4)	1999
Baltimore, MD	639	1.3%	1999
Detroit, MI	821	1.7%	1999
Denver, CO	632	1.3%	2000
Seattle, WA	779	1.6%	2000
Cleveland, OH	654	1.3%	2000
Miami, FL	769	1.6%	2000
St. Louis, MO	449	0.9%	2000
Total	21,878	44.7%	

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(1) Data as of December 31, 1996.

(2) Based on an estimated 49.0 million U.S. non-residential access lines as of December 31, 1996.

(3) Refers to the first month during which Allegiance could offer facilities-based service or the year during which Allegiance expects to be able to offer facilities-based service based on its current business plan.

(4) Data for New York City also includes Northern New Jersey and Long Island, NY.

(5) Data for Dallas, TX also includes Fort Worth, TX.

(6) Data for Los Angeles, CA also includes Orange County, CA.

(7) Data for San Francisco, CA also includes San Jose, CA and Oakland, CA.

In the majority of its targeted markets, Allegiance will initially deploy switches and collocate transmission equipment in ILEC central offices with heavy concentrations of non-residential access lines. Over time, Allegiance plans to expand its networks throughout the metropolitan areas to address the majority of the business market in each area. In some markets, such as Northern New Jersey, Allegiance will not initially deploy its own switch, but will deploy transmission equipment in major central offices and route traffic to an existing Allegiance switch until traffic growth warrants the addition of a switch to service that market.

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NETWORK ARCHITECTURE

An important element of Allegiance's smart build strategy is the installation of Lucent Series 5ESS(R)-2000 digital switches and related equipment at a central location in each market. As of December 31, 1998, Allegiance had deployed seven switches to serve nine markets: New York City, Dallas, Atlanta, Chicago, Los Angeles, San Francisco, Fort Worth, Oakland and Boston.

Initially, Allegiance intends to lease local network trunking facilities from the ILEC and/or one or more CLECs in order to connect Allegiance's switch to major ILEC central offices serving the central business district and outlying areas of business concentrations in each market. The switch will also be connected to ILEC tandem switches and certain interexchange carrier points-of-presence, the equivalent of a local phone company's central office. To access the largest number of customers possible without having to lay fiber to each of their premises, Allegiance will also locate access equipment such as integrated digital loop carriers and related equipment in each of the ILEC central offices in which it is connected.

As each customer is signed up, service will be provided by leasing unbundled loops from the ILEC to connect Allegiance's integrated digital loop carriers located in the serving central office to the customer premise equipment. For large business, government, or other institutional customers or for numerous customers located in large buildings, it may be more cost-effective for Allegiance to use leased ILEC or CLEC capacity in the 1.5 to 150 megabit range, or perhaps a wireless local loop leased from one of the emerging wireless CLECs, to connect the customer(s) to the Allegiance network. In this case, Allegiance will locate its integrated digital loop carriers or other equipment in the customer's building.

Although Allegiance will initially lease its local network transmission facilities, Allegiance plans to replace leased capacity with its own fiber optic facilities as and when it experiences sufficient traffic volume growth between its switch and specific ILEC central offices or as other factors make these arrangements more attractive.

IMPLEMENTATION OF SERVICES

To offer services in a market, Allegiance generally must secure certification from the state regulator and typically must file tariffs or price lists for the services that it will offer. The certification process varies from state to state; however, the fundamental requirements are largely the same. State regulators require new entrants to demonstrate that they have secured adequate financial resources to establish and maintain good customer service. New entrants must also show that they possess the knowledge and ability required to establish and operate a telecommunications network. Allegiance has made such demonstrations in Texas, Georgia, California, Illinois, Maryland, New York, New Jersey, Virginia, Massachusetts and Washington, D.C., where Allegiance has obtained certificates to provide local exchange and intrastate toll services. Applications for such authority are pending in Colorado, Michigan, Washington and Pennsylvania, where Allegiance has obtained interim operating authority. Allegiance intends to file similar applications in the near future in Ohio, Missouri and Florida.

Before providing local service, a new entrant must negotiate and execute an interconnection agreement with the ILEC. While such agreements can be voluminous and may take months to negotiate, most of the key interconnection issues have now been thoroughly addressed and commissions in most states have ruled on arbitrations between the ILECs and new entrants. However, interconnection rates and conditions may be subject to change as the result of future commission actions or other changes in the regulatory environment. Under a recent United States Supreme Court ruling, new entrants may adopt either all or portions of an interconnection agreement already entered into by the ILEC and another carrier. Such an approach will be selectively adopted by Allegiance to enable it to enter markets quickly while at the same time preserving its right to replace the adopted agreement with a customized interconnection agreement that can be negotiated once service has already been established. For example, Allegiance has adopted the interconnection agreement entered into between Southwestern Bell and WinStar Wireless of Texas, Inc. in Texas and has begun to negotiate enhancements to that agreement for ultimate inclusion in Allegiance's customized agreement with Southwestern Bell.

While such interconnection agreements include key terms and prices for interconnection, a significant joint implementation effort must be made with the ILEC in order to establish operationally efficient and reliable traffic interchange arrangements. Such interchange arrangements must include those between the new entrant's network and the facilities of other service providers as well as public service agencies. For example, Allegiance worked closely with Southwestern Bell in order to devise and implement an efficient 911 call routing plan that will meet the

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requirements of each individual 911 service bureau in Southwestern Bell areas that Allegiance will serve using its own switches. Allegiance meets with key personnel from 911 service bureaus to obtain their acceptance and to establish dates for circuit establishment and joint testing. Other examples of traffic interchange and interconnection arrangements utilizing the ILEC's network include connectivity to its out-of-band signaling facilities, interconnectivity to the ILEC's operator services and directory assistance personnel, and access through the ILEC to the networks of wireless companies and interexchange carriers.

Allegiance has entered into interconnection agreements with the ILECs in each of the states in which its current eleven geographic markets are located. In Georgia, New York and Texas, however, the original interconnection agreements have expired. Allegiance is operating under the terms of these agreements while negotiating new interconnection agreements. The new agreements will likely have retroactive effective dates.

After the initial implementation activities are completed in a market, Allegiance follows an on-going capacity management plan to ensure that adequate quantities of network facilities, such as interconnection trunks are in place, and a contingency plan must be devised to address spikes in demand caused by events such as a larger-than-expected customer sale in a relatively small geographic area.

REGULATION

Allegiance's telecommunications services business is subject to federal, state and local regulation.

Federal Regulation

The FCC regulates interstate and international telecommunications services, including the use of local telephone facilities to originate and terminate interstate and international calls. Allegiance provides such services on a common carrier basis. The FCC imposes certain regulations on common carriers such as the ILECs that have some degree of market power. The FCC imposes less regulation on common carriers without market power including, to date, CLECs like Allegiance. The FCC requires common carriers to receive an authorization to construct and operate telecommunications facilities, and to provide or resell telecommunications services, between the United States and international points.

Under the Telecommunications Act, any entity, including cable television companies and electric and gas utilities, may enter any telecommunications market, subject to reasonable state regulation of safety, quality and consumer protection. Because implementation of the Telecommunications Act is subject to numerous federal and state policy rulemaking proceedings and judicial review there is still uncertainty as to what impact such legislation will have on Allegiance.

The Telecommunications Act is intended to increase competition. The act opens the local services market by requiring ILECs to permit interconnection to their networks and establishing ILEC obligations with respect to:

Reciprocal Compensation. Requires all local exchange carriers to complete calls originated by competing local exchange carriers under reciprocal arrangements at prices based on tariffs or negotiated prices.

Resale. Requires all ILECs and CLECs to permit resale of their telecommunications services without unreasonable restrictions or conditions. In addition, ILECs are required to offer wholesale versions of all retail services to other telecommunications carriers for resale at discounted rates, based on the costs avoided by the ILEC in the wholesale offering.

Interconnection. Requires all ILECs and CLECs to permit their competitors to interconnect with their facilities. Requires all ILECs to permit interconnection at any technically feasible point within their networks, on nondiscriminatory terms, at prices based on cost, which may include a reasonable profit. At the option of the carrier seeking interconnection, collocation of the requesting carrier's equipment in the ILECs' premises must be offered, except where an ILEC can demonstrate space limitations or other technical impediments to collocation.

Unbundled Access. Requires all ILECs to provide nondiscriminatory access to unbundled network elements including, network facilities, equipment, features, functions, and capabilities, at any technically feasible point within their networks, on nondiscriminatory terms, at prices based on cost, which may include a reasonable profit.

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Number Portability. Requires all ILECs and CLECs to permit users of telecommunications services to retain existing telephone numbers without impairment of quality, reliability or convenience when switching from one telecommunications carrier to another.

Dialing Parity. Requires all ILECs and CLECs to provide "1+" equal access to competing providers of telephone exchange service and toll service, and to provide nondiscriminatory access to telephone numbers, operator services, directory assistance, and directory listing, with no unreasonable dialing delays.

Access to Rights-of-Way. Requires all ILECs and CLECs to permit competing carriers access to poles, ducts, conduits and rights-of-way at regulated prices.

ILECs are required to negotiate in good faith with carriers requesting any or all of the above arrangements. If the negotiating carriers cannot reach agreement within a prescribed time, either carrier may request binding arbitration of the disputed issues by the state regulatory commission. Where an agreement has not been reached, ILECs remain subject to interconnection obligations established by the FCC and state telecommunication regulatory commissions.

In August 1996, the FCC released a decision establishing rules implementing the ILEC interconnection obligations described above. On July 18, 1997, the Eighth Circuit vacated certain portions of this decision and narrowly interpreted the FCC's power to prescribe and enforce rules implementing the Telecommunications Act. On January 25, 1999, the United States Supreme Court reversed the Eighth Circuit decision and reaffirmed the FCC's broad authority to issue rules implementing the Telecommunications Act, although it did vacate a rule determining which network elements the incumbent local exchange carriers must provide to competitors on an unbundled basis. Allegiance, however, leases only the basic unbundled network elements from the ILEC and therefore does not expect reconsideration of the unbundling rules to have an adverse effect on its smart build strategy.

Nevertheless, the FCC likely will conduct additional rulemaking proceedings to conform to the Supreme Court's interpretation of the law, and these proceedings may result in further judicial review. While these court proceedings were pending, Allegiance entered into interconnection agreements with a number of ILECs through negotiations or, in some cases, adoption of another CLEC's approved agreement. These agreements remain in effect, although in some cases one or both parties may be entitled to demand renegotiation of particular provisions based on intervening changes in the law. However, it is uncertain whether Allegiance will be able to obtain renewal of these agreements on favorable terms when they expire.

The Telecommunications Act codifies the ILECs' equal access and nondiscrimination obligations and preempts inconsistent state regulation. The Telecommunications Act also contains special provisions that replace prior antitrust restrictions that prohibited the regional Bell operating companies from providing long distance services and engaging in telecommunications equipment manufacturing. The Telecommunications Act permitted the regional Bell operating companies to enter the out-of-region long distance market immediately upon its enactment. Further, provisions of the Telecommunications Act permit a regional Bell operating company to enter the long distance market in its in-region states if it satisfies several procedural and substantive requirements, including:

o obtaining FCC approval upon a showing that the regional Bell operating company has entered into interconnection agreements or, under some circumstances, has offered to enter into such agreements in those states in which it seeks long distance relief;

o the interconnection agreements satisfy a 14-point "checklist" of competitive requirements; and

o the FCC is satisfied that the regional Bell operating company's entry into long distance markets is in the public interest.

To date, several petitions by regional Bell operating companies for such entry have been denied by the FCC, and none have been granted. However, it is likely that additional petitions will be filed in 1999 and it is possible that regional Bell operating companies may receive approval to offer long distance services in one or more states. This may have an unfavorable effect on Allegiance's business. Allegiance is legally able to offer its customers both long distance and local exchange services, which the regional Bell operating companies currently may not do. This ability to offer "one-stop shopping" gives Allegiance a marketing advantage that it would no longer enjoy. See "-- Competition."

On May 8, 1997, the FCC released an order establishing a significantly expanded federal universal service subsidy regime. For example, the FCC established new subsidies for telecommunications and information services provided to qualifying schools and libraries with an annual cap of $2.25 billion and for services provided to rural health care providers with an annual cap of $400 million. The FCC also expanded the federal subsidies for local exchange telephone services provided to low-income consumers. Providers of interstate telecommunications service, such as Allegiance must pay for a portion of these programs. Allegiance's share of these federal subsidy funds will be based on its share of certain defined telecommunications end user revenues. Currently, the FCC is assessing such payments on the basis of a provider's revenue for the previous year. The FCC announced that it intends, effective July 1, 1999, to revise its rules for subsidizing service provided to consumers in high cost areas, which may result in further substantial increases in the overall cost of the subsidy program. Several parties have appealed the May 8th order. Such appeals have been consolidated and transferred to the United States Court of Appeals for the Fifth Circuit where they are currently pending.

For the first half of 1999, Allegiance expects to incur a contribution liability equal to approximately 1.5% of its 1998 operating revenues. With respect to subsequent periods, however, Allegiance is currently unable to quantify the amount of subsidy payments that it will be required to make or the effect that these required payments will have on its financial condition.

Under authority granted by the FCC, Allegiance will resell the international telecommunications services of other common carriers between the United States and international points. In connection with such authority, Allegiance's subsidiary, Allegiance Telecom International, Inc., has filed tariffs with the FCC stating the rates, terms and conditions for its international services.

With respect to its domestic service offerings, various subsidiaries of Allegiance have filed tariffs with the FCC stating the rates, terms and conditions for their interstate services. Allegiance's tariffs are generally not subject to pre-effective review by the FCC, and can be amended on one day's notice. Allegiance's interstate services are provided in competition with interexchange carriers and, with respect to access services, the ILECs. With limited exceptions, the current policy of the FCC for most interstate access services dictates that ILECs charge all customers the same price for the same service. Thus, the ILECs generally cannot lower prices to those customers likely to contract for their services without also lowering charges for the same service to all customers in the same geographic area, including those whose telecommunications requirements would not justify the use of such lower prices. The FCC may, however, alleviate this constraint on the ILECs and permit them to offer special rate packages to very large customers, as it has done in a few cases, or permit other forms of rate flexibility. The FCC has adopted some proposals that significantly lessen the regulation of ILECs that are subject to competition in their service areas and provide such ILECs with additional flexibility in pricing their interstate switched and special access on a central office specific basis; and, as discussed in the following paragraph, is considering expanding such flexibility.

In two orders released on December 24, 1996, and May 16, 1997, the FCC made major changes in the interstate access charge structure. In the December 24th order, the FCC removed restrictions on ILECs' ability to lower access prices and relaxed the regulation of new switched access services in those markets where there are other providers of access services. If this increased pricing flexibility is not effectively monitored by federal regulators, it could have a material adverse effect on Allegiance's ability to compete in providing interstate access services. The May 16th order substantially increased the costs that ILECs subject to the FCC's price cap rules recover through monthly, non-traffic sensitive access charges and substantially decreased the costs that these carriers recover through traffic sensitive access charges. In the May 16th order, the FCC also announced its plan to bring interstate access rate levels more in line with cost. The plan will include rules that may grant these carriers increased pricing flexibility upon demonstrations of increased competition or potential competition in relevant markets. The manner in which the FCC implements this approach to lowering access charge levels could have a material effect on Allegiance's ability to compete in providing interstate access services. Several parties appealed the May 16th order. On August 19, 1998, the May 16th order was affirmed by the Eighth Circuit U.S. Court of Appeals. The FCC is now considering public comments on pricing flexibility proposals submitted by two regional Bell operating companies and on changing the productivity factor (currently 6.5%), which is applied annually to reduce ILECs' price cap indices.

ILECs around the country have been contesting whether the obligation to pay reciprocal compensation to competitive local exchange carriers should apply to local telephone calls from an ILEC's customers to Internet service providers served by competitive local exchange carriers. The ILECs claim that this traffic is interstate in nature and therefore should be exempt from compensation arrangements applicable to local, intrastate calls. Competitive local exchange carriers have contended that the interconnection agreements provide no exception for

local calls to Internet service providers and reciprocal compensation is therefore applicable. Currently, over 25 state commissions and several federal and state courts have ruled that reciprocal compensation arrangements do apply to calls to Internet service providers, and no jurisdiction has ruled to the contrary. Certain of these rulings are subject to appeal. Additional disputes over the appropriate treatment of Internet service provider traffic are pending in other states.

On February 26, 1999, the FCC released a Declaratory Ruling determining that Internet service provider traffic is interstate for jurisdictional purposes, but that its current rules neither require nor prohibit the payment of reciprocal compensation for such calls. In the absence of a federal rule, the FCC determined that state commissions have authority to interpret and enforce the reciprocal compensation provisions of existing interconnection agreements, and to determine the appropriate treatment of Internet service provider traffic in arbitrating new agreements. The FCC also requested comment on alternative federal rules to govern compensation for such calls in the future. In response to the FCC ruling, some regional Bell operating companies have asked state commissions to reopen previous decisions requiring the payment of reciprocal compensation on Internet service provider calls.

Allegiance anticipates that Internet service providers will be among its target customers, and adverse decisions in state proceedings could limit its ability to service this group of customers profitably. Allegiance limits the switch capacity used for Internet service provider lines to 20%. In addition, given the uncertainty as to whether reciprocal compensation should be payable in connection with calls to Internet service providers, Allegiance recognizes such revenue only when realization of it is certain, which in most cases will be upon receipt of cash.

State Regulation

The Telecommunications Act is intended to increase competition in the telecommunications industry, especially in the local exchange market. With respect to local services, ILECs are required to allow interconnection to their networks and to provide unbundled access to network facilities, as well as a number of other procompetitive measures. Because the implementation of the Telecommunications Act is subject to numerous state rulemaking proceedings on these issues, it is currently difficult to predict how quickly full competition for local services, including local dial tone, will be introduced.

State regulatory agencies have regulatory jurisdiction when Allegiance facilities and services are used to provide intrastate services. A portion of Allegiance's current traffic may be classified as intrastate and therefore subject to state regulation. Allegiance expects that it will offer more intrastate services, including intrastate switched services, as its business and product lines expand and state regulations are modified to allow increased local services competition. To provide intrastate services, Allegiance generally must obtain a certificate of public convenience and necessity from the state regulatory agency and comply with state requirements for telecommunications utilities, including state tariffing requirements.

State agencies, like the FCC, require Allegiance to file periodic reports, pay various fees and assessments, and comply with rules governing quality of service, consumer protection, and similar issues. Although the specific requirements vary from state to state, they tend to be more detailed than the FCC's regulation because of the strong public interest in the quality of basic local exchange service. Allegiance intends to comply with all applicable state regulations, and as a general matter does not expect that these requirements of industry-wide applicability will have a material adverse effect on its business. However, no assurance can be given that the imposition of new regulatory burdens in a particular state will not affect the profitability of Allegiance's services in that state.

Local Regulation

Allegiance's networks are subject to numerous local regulations such as building codes and licensing. Such regulations vary on a city by city and county by county basis. If Allegiance decides in the future to install its own fiber optic transmission facilities, it will need to obtain rights-of-way over private and publicly owned land. There can be no assurance that such rights-of-way will be available to Allegiance on economically reasonable or advantageous terms.

COMPETITION

The telecommunications industry is highly competitive. Allegiance believes that the principal competitive factors affecting its business will be pricing levels and clear pricing policies, customer service, accurate billing and, to a

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lesser extent, variety of services. The ability of Allegiance to compete effectively will depend upon its continued ability to maintain high quality, market-driven services at prices generally equal to or below those charged by its competitors. To maintain its competitive posture, Allegiance believes that it must be in a position to reduce its prices in order to meet reductions in rates, if any, by others. Any such reductions could adversely affect Allegiance. Many of Allegiance's current and potential competitors have financial, personnel and other resources, including brand name recognition, substantially greater than those of Allegiance, as well as other competitive advantages over Allegiance.

Local Exchange Carriers. In each of the markets targeted by Allegiance, Allegiance will compete principally with the ILEC serving that area, such as Ameritech, BellSouth, Southwestern Bell, Bell Atlantic or US WEST. Allegiance believes the regional Bell operating companies' primary agenda is to be able to offer long distance service in their service territories. The independent telephone companies have already achieved this goal with good early returns. Many experts expect the regional Bell operating companies to be successful in entering the long distance market in a few states sometime in 1999. Allegiance believes the regional Bell operating companies expect to offset share losses in their local markets by capturing a significant percentage of the in-region long distance market, especially in the residential segments where the regional Bell operating companies' strong regional brand names and extensive advertising campaigns may be very successful. See "-- Regulation."

As a recent entrant in the integrated telecommunications services industry, Allegiance has not achieved and does not expect to achieve a significant market share for any of its services. In particular, the ILECs have long-standing relationships with their customers, have financial, technical and marketing resources substantially greater than those of Allegiance, have the potential to subsidize competitive services with revenues from a variety of businesses and currently benefit from certain existing regulations that favor the ILECs over Allegiance in certain respects. While recent regulatory initiatives, which allow CLECs such as Allegiance to interconnect with ILEC facilities, provide increased business opportunities for Allegiance, such interconnection opportunities have been and likely will continue to be accompanied by increased pricing flexibility for and relaxation of regulatory oversight of the ILECs.

ILECs have long-standing relationships with regulatory authorities at the federal and state levels. While recent FCC administrative decisions and initiatives provide increased business opportunities to telecommunications providers such as Allegiance, they also provide the ILECs with increased pricing flexibility for their private line and special access and switched access services. In addition, with respect to competitive access services as opposed to switched access services, the FCC recently proposed a rule that would provide for increased ILEC pricing flexibility and deregulation for such access services either automatically or after certain competitive levels are reached. If the ILECs are allowed by regulators to offer discounts to large customers through contract tariffs, engage in aggressive volume and term discount pricing practices for their customers, and/or seek to charge competitors excessive fees for interconnection to their networks, the income of competitors to the ILECs, including Allegiance, could be materially adversely affected. If future regulatory decisions afford the ILECs increased access services pricing flexibility or other regulatory relief, such decisions could also have a material adverse effect on competitors to the ILEC, including Allegiance.

Competitive Access Carriers/Competitive Local Exchange Carriers/Interexchange Carriers/ Other Market Entrants. Allegiance also faces, and expects to continue to face, competition from other current and potential market entrants, including long distance carriers seeking to enter, reenter or expand entry into the local exchange market such as AT&T, MCI WorldCom, and Sprint, and from other CLECs, resellers of local exchange services, competitive access providers, cable television companies, electric utilities, microwave carriers, wireless telephone system operators and private networks built by large end users. In addition, a continuing trend toward consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors to Allegiance. For example, WorldCom acquired MFS Communications in December 1996, acquired another CLEC, Brooks Fiber Properties, Inc. in 1997, and recently merged with MCI. AT&T recently acquired Teleport Communications Group Inc., a CLEC, and TeleCommunications, Inc., a cable, telecommunications and high-speed Internet services provider. Ameritech Corporation has agreed to merge with SBC Communications; and Bell Atlantic has agreed to merge with GTE Corporation. These types of consolidations and strategic alliances could put Allegiance at a competitive disadvantage.

The Telecommunications Act includes provisions which impose certain regulatory requirements on all local exchange carriers, including competitors such as Allegiance, while granting the FCC expanded authority to reduce the level of regulation applicable to any or all telecommunications carriers, including ILECs. The manner in which

these provisions of the Telecommunications Act are implemented and enforced could have a material adverse effect on Allegiance's ability to successfully compete against ILECs and other telecommunications service providers. Allegiance also competes with equipment vendors and installers, and telecommunications management companies with respect to certain portions of its business.

The changes in the Telecommunications Act radically altered the market opportunity for traditional competitive access providers and CLECs. Due to the fact that most existing competitive access providers/ CLECs initially entered the market providing dedicated access in the pre-1996 era, these companies had to build a fiber infrastructure before offering services. Switches were added by most competitive access providers/CLECs in the last year to take advantage of the opening of the local market. With the Telecommunications Act requiring unbundling of the local exchange carrier networks, competitive access providers/CLECs will now be able to more rapidly enter the market by installing switches and leasing trunk and loop capacity until traffic volume justifies building facilities. New CLECs will not have to replicate existing facilities and can be more opportunistic in designing and implementing networks.

A number of CLECs have entered or announced their intention to enter into one or more of the same markets as Allegiance. Allegiance believes that not all CLECs however, are pursuing the same target customers as Allegiance. Demographically, business customers are divided into three categories: small, medium and large. Targeted cities are divided into three groups by population: Tier 1, Tier 2 and Tier 3. As would be expected, each CLEC may focus on different combinations of primary and secondary target customers.

Allegiance has chosen to focus primarily on small and medium-sized business customers in large "Tier 1" markets. To help distinguish itself from other competitors who have adopted a similar strategy, Allegiance uses a direct sales approach to offer potential customers "one-stop shopping" services through a single point of contact. In addition, Allegiance is actively pursuing collocations throughout all of its target markets which, in combination with its smart build strategy, is expected to allow Allegiance to access its markets and provide a greater array of services more quickly than if it were able to use a traditional build approach.

Allegiance believes the major interexchange carriers, such as AT&T, MCI WorldCom and Sprint, have a two pronged strategy:

o keep the regional Bell operating companies out of in-region long distance as long as possible, and o develop facilities-based and unbundled local service, an approach already being pursued by MCI WorldCom with the acquisition of MFS Communications, and more recently by AT&T with its acquisitions of Teleport Communications and TeleCommunications, Inc.

Competition for Provision of Long Distance Services. The long distance telecommunications industry has numerous entities competing for the same customers and a high average turnover rate, as customers frequently change long distance providers in response to the offering of lower rates or promotional incentives by competitors. Prices in the long distance market have declined significantly in recent years and are expected to continue to decline. Allegiance expects to increasingly face competition from companies offering long distance data and voice services over the Internet. Such companies could enjoy a significant cost advantage because they do not currently pay carrier access charges or universal service fees.

Data/Internet Service Providers. The Internet services market is highly competitive, and Allegiance expects that competition will continue to intensify. Allegiance's competitors in this market will include Internet service providers, other telecommunications companies, online services providers and Internet software providers. Many of these competitors have greater financial, technological and marketing resources than those available to Allegiance.

Competition from International Telecommunications Providers. Under the recent World Trade Organization agreement on basic telecommunications services, the United States and 72 other members of the World Trade Organization committed themselves to opening their respective telecommunications markets and/or foreign ownership and/or to adopting regulatory measures to protect competitors against anticompetitive behavior by dominant telecommunications companies, effective in some cases as early as January 1998. Although Allegiance believes that this agreement could provide Allegiance with significant opportunities to compete in markets that were not previously accessible and to provide more reliable services at lower costs than Allegiance could have provided prior to implementation of this agreement, it could also provide similar opportunities to Allegiance's competitors and facilitate entry by foreign carriers into the U.S. market. There can be no assurance that the pro-competitive effects of

the World Trade Organization agreement will not have a material adverse effect on Allegiance's business, financial condition and results of operations or that members of the World Trade Organization will implement the terms of this agreement.

EMPLOYEES

As of December 31, 1998, Allegiance had approximately 649 full-time employees. Allegiance believes that its future success will depend on its continued ability to attract and retain highly skilled and qualified employees. None of Allegiance's employees are currently represented by a collective bargaining agreement. Allegiance believes that it enjoys good relationships with its employees.

RISK FACTORS

OUR FORWARD-LOOKING STATEMENTS MAY MATERIALLY DIFFER FROM ACTUAL EVENTS OR RESULTS

This report, including the discussion under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains "forward-looking statements," which you generally can identify by our use of forward-looking words such as "believes," "expects," "may," "will," "should" or "anticipates" or the negative or other variations of such terms or comparable terminology, or by discussion of strategy that involve risks and uncertainties. We often use these types of statements when discussing our plans and strategies, our anticipation of revenues from designated markets, and statements regarding the development of our businesses, the markets for our services and products, our anticipated capital expenditures, operations support systems, changes in regulatory requirements and other statements contained in this report regarding matters that are not historical facts.

We caution you that these forward-looking statements are only predictions and estimates regarding future events and circumstances. We cannot assure you that we will achieve the future results reflected in these statements. The risks we face that could cause us not to achieve these results include, but are not limited to our ability to do the following in a timely manner, at reasonable costs and on satisfactory terms and conditions:

- successfully market our services to current and new customers;
- connect with and develop cooperative working relationships with incumbent local exchange carriers;
- develop efficient operations support systems and other back office systems;
- successfully and efficiently transfer new customers to our networks and access new geographic markets;
- identify, finance and complete suitable acquisitions;
- borrow under our senior credit facility;
- install new switching facilities and other network equipment; and
- obtain leased fiber optic line capacity, rights-of-way, building access rights and any required governmental authorizations, franchises and permits.

Regulatory, legislative and judicial developments could also cause actual results to differ materially from the future results reflected in such forward-looking statements. You should consider all of our subsequent written and oral forward-looking statements only in light of such cautionary statements. You should not place undue reliance on these forward-looking statements and you should understand that they speak only as of the dates we make them. Important factors that could cause our actual results to be materially different from the forward-looking statements are disclosed in this "Risk Factors" section and throughout this report.

OUR LIMITED HISTORY OF OPERATIONS MAY NOT BE A RELIABLE BASIS FOR EVALUATING OUR PROSPECTS

Because of our short operating history, you have limited operating and financial data which you can use to evaluate our performance. From our inception on April 22, 1997 through December 16, 1997, we were in the development stage of operations.

IF WE DO NOT EFFECTIVELY MANAGE RAPID EXPANSION OF OUR BUSINESS, OUR FINANCIAL CONDITION WILL SUFFER

We are in the early stages of our operations and have only recently begun to deploy networks in our first 17 target markets. If we are successful in the implementation of our business plan, we will be rapidly expanding our operations and providing bundled telecommunications services on a widespread basis. This rapid expansion may

place a significant strain on our management, financial and other resources. If we fail to manage our growth effectively, we may not be able to expand our customer base and service offerings as we have planned.

OUR SUCCESS DEPENDS ON OUR KEY PERSONNEL AND WE MAY NOT BE ABLE TO REPLACE KEY EXECUTIVES WHO LEAVE

We are managed by a small number of key executive officers, most notably Royce J. Holland, our Chairman and Chief Executive Officer. The loss of services of one or more of these key individuals, particularly Mr. Holland, could materially and adversely affect our business and our prospects. Most of our executive officers do not have employment agreements, and we do not maintain key person life insurance for any of our executive officers. The competition for qualified personnel in the telecommunications industry is intense. For this reason, we cannot assure you that we will be able to hire or retain necessary personnel in the future.

WE ARE DEPENDENT ON EFFECTIVE BILLING, CUSTOMER SERVICE AND INFORMATION SYSTEMS AND WE MAY HAVE DIFFICULTIES IN DEVELOPING THESE SYSTEMS

Sophisticated back office information and processing systems are vital to our growth and our ability to monitor costs, bill customers, initiate, implement and track customer orders and achieve operating efficiencies. We cannot assure you that these systems will be successfully implemented on a timely basis or at all or will perform as expected because:

- our vendors may fail to deliver proposed products and services in a timely and effective manner and at acceptable costs;
- we may fail to adequately identify all of our information and processing needs;
- our processing or information systems may fail or be inadequate;
- we may be unable to effectively integrate such products or services;
- we may fail to upgrade systems as necessary; and
- third party vendors may cancel or fail to renew license agreements that relate to these systems.

WE MAY BE ADVERSELY IMPACTED BY YEAR 2000 ISSUES, MANY OF WHICH ARE BEYOND OUR CONTROL

The "year 2000" issue generally describes the various problems that may result from the improper processing of dates and date-sensitive transactions by computers and other equipment as a result of computer hardware and software using two digits to identify the year in a date. The failure to process dates could result in network and system failures or miscalculations causing disruptions in operations including, among other things, a temporary inability to process transactions, send invoices or engage in other routine business activities. A failure of our customers or vendors, including other telecommunications operators, to cause their software and systems to be year 2000 compliant could have a material adverse effect on us and on our ability to meet our obligations. Until the year 2000 occurs, we will not know for sure that all systems will then function adequately. In addition, we are dependent upon third-party suppliers, including other telecommunications operators, for the delivery of interconnection and other services and on third-party customers for the purchase of our services. In many cases, our services and operations require electronic interfacing with the systems and networks of third-party telecommunication operators such as the incumbent local exchange carriers.

WE FACE POTENTIAL CONFLICTS OF INTEREST CAUSED BY FUND INVESTOR CONTROL WHICH COULD BE DETRIMENTAL TO HOLDERS OF OUR SECURITIES

You should be aware that the investment funds that provided our initial equity hold a majority of our board seats and a significant amount of our common stock and that as a result, our direction and future operations may be controlled by these funds. For a discussion of the voting agreement among our original fund and management investors regarding the election of nominees to the board of directors, see the discussion under Item 13, "Certain Relationships and Related Transactions" of this report. In addition, decisions concerning our operations or financial structure may present conflicts of interest between these investors and our management and other holders of our securities, including our notes. In addition to their investments in us, these investors or their affiliates currently have significant investments in other telecommunications companies and may in the future invest in other entities engaged in the telecommunications business or in related businesses, including entities that compete with us. Conflicts may also arise in the negotiation or enforcement of arrangements entered into by us and entities in which these investors have an interest.

UNDER CERTAIN CIRCUMSTANCES WE MAY NEED ADDITIONAL CAPITAL TO EXPAND OUR BUSINESS AND INCREASE REVENUE

We may need additional capital to fund capital expenditures, working capital, debt service and cash flow deficits during the period in which we are expanding and developing our business and deploying our networks, services and systems. We estimate, based on our current business plan, that approximately $750 to $850 million of capital will be necessary to fund the deployment and operation of our networks in all of our initial 24 markets to the point at which operating cash flow from a market will be sufficient to fund such market's operating and capital expenditures. This amount includes capital expenditures, working capital and cash flow deficits, but excludes debt service. We have raised approximately $554 million of capital to date. The actual amount and timing of our future capital requirements may differ materially from our estimates as a result of financial, business and other factors many of which are beyond our control, as well as prevailing economic conditions.

We believe that the proceeds from our anticipated common stock offering and borrowings expected to be available under a senior credit facility, together with our cash on hand, will be sufficient to pre-fund market deployment in all 24 targeted markets. However, we have not yet entered into the credit facility and if established, we will only be able to borrow under the credit facility if we are in compliance with certain financial covenants. In the event we cannot borrow under the credit facility we may need to access alternative sources of capital. If we are unable to do so we may not be able to expand as we expect, which may have an adverse effect on us.

OUR SUBSTANTIAL INDEBTEDNESS COULD MAKE US UNABLE TO SERVICE INDEBTEDNESS AND MEET OUR OTHER REQUIREMENTS AND COULD ADVERSELY AFFECT OUR FINANCIAL HEALTH

We have a significant amount of debt outstanding and plan to access additional debt financing to fund our business plan. On December 31, 1998, we had $471.7 million of outstanding indebtedness and $110.4 million of stockholders' equity. We anticipate incurring additional indebtedness in the future, including a senior secured revolving credit facility that we expect to close in April 1999. See the discussion of this credit facility in the section titled "Recent Developments."

This level of debt could:

o impair our ability to obtain additional financing for working capital, capital expenditures, acquisitions or general corporate purposes;

o require us to dedicate a substantial portion of our cash flow from operations to the payment of principal and interest on our indebtedness, thereby reducing the funds available for the growth of our networks;

o place us at a competitive disadvantage with those of our competitors who do not have as much debt as we do;

o impair our ability to adjust rapidly to changing market conditions; and

o make us more vulnerable if there is a downturn in general economic conditions or in our business.

The successful implementation of our business plan is essential for us to meet our working capital, capital expenditure and debt service requirements. Allegiance's earnings for the year ended December 31, 1998 were insufficient to cover fixed charges by approximately $249.3 million. We cannot assure you that we will be able to meet our working capital, capital expenditure and debt service requirements.

LIMITATIONS IMPOSED BY RESTRICTIVE COVENANTS COULD LIMIT HOW WE CONDUCT BUSINESS AND A DEFAULT UNDER OUR INDENTURES AND FINANCING AGREEMENTS COULD SIGNIFICANTLY IMPACT OUR ABILITY TO REPAY OUR INDEBTEDNESS

Our indentures and the agreements entered into in connection with our initial equity funding contain covenants that restrict our ability to:

o incur additional indebtedness;

o pay dividends and make other distributions;

o prepay subordinated indebtedness;

o make investments and other restricted payments;

o enter into sale and leaseback transactions;

o create liens;

o sell assets; and

o engage in certain transactions with affiliates.

Our future financing arrangements, including the senior secured revolving credit facility discussed in the section titled "Recent Developments" will most likely contain similar or more restrictive covenants, as well as other covenants that will require us to maintain specified financial ratios and satisfy financial tests. As a result of these restrictions, we are limited in how we conduct business and we may be unable to raise additional debt or equity financing to operate during general economic or business downturns, to compete effectively or to take advantage of new business opportunities. This may affect our ability to generate revenues and make profits. Without sufficient revenues and cash, we may not be able to pay interest and principal on our indebtedness.

Our failure to comply with the covenants and restrictions contained in our indentures and other financing agreements could lead to a default under the terms of these agreements. If such a default occurs, the other parties to such agreements could declare all amounts borrowed and all amounts due under other instruments that contain provisions for cross-acceleration or cross-default due and payable. In addition, lenders under our future financing arrangements could terminate their commitments to lend to us. If that occurs, we cannot assure you that we would be able to make payments on our indebtedness, meet our working capital and capital expenditure requirements, or that we would be able to find additional alternative financing. Even if we could obtain additional alternative financing, we cannot assure you that it would be on terms that are favorable or acceptable to us.

WE MAY NOT HAVE THE FUNDS NECESSARY TO FINANCE THE CHANGE OF CONTROL OFFER WHICH MAY BE REQUIRED BY OUR INDENTURES

Our indentures provide that upon a change of control, each note holder will have the right to require us to purchase all or a portion of such holder's notes. We would be required to purchase the notes at a purchase price of 101% of the accreted value of the 11 3/4% notes and 101% of the principal amount of the 12 7/8% notes, plus any accrued and unpaid interest to the date of repurchase. It is possible that we will not have sufficient funds at that time to repurchase our notes.

IF WE DO NOT INTERCONNECT WITH OUR PRIMARY COMPETITORS, THE INCUMBENT LOCAL EXCHANGE CARRIERS, OUR BUSINESS WILL BE ADVERSELY AFFECTED

Many new carriers, including Allegiance, have experienced difficulties in working with the incumbent local exchange carriers with respect to initiating, interconnecting, and implementing the systems used by these new carriers to order and receive unbundled network elements and wholesale services and locating the new carriers' equipment in the offices of the incumbent local exchange carriers. As a new carrier, we must coordinate with incumbent local exchange carriers so that we can provide local service to customers on a timely and competitive basis. The Telecommunications Act created incentives for regional Bell operating companies to cooperate with new carriers and permit access to their facilities by denying such companies the ability to provide in-region long distance services until they have satisfied statutory conditions designed to open their local markets to competition. The regional Bell operating companies in our markets are not yet permitted by the FCC to offer long distance services. These companies may not be accommodating to us once they are permitted to offer long distance service. If we cannot obtain the cooperation of a regional Bell operating company in a region, whether or not it has been authorized to offer long distance service, our ability to offer local services in such region on a timely and cost-effective basis will be adversely affected.

IF WE DO NOT OBTAIN PEERING ARRANGEMENTS WITH INTERNET SERVICE PROVIDERS, THE PROFITABILITY OF OUR INTERNET ACCESS SERVICES WILL SUFFER

The profitability of our Internet access services, and related services such as Web site hosting, may be adversely affected if we are unable to obtain "peering" arrangements with Internet service providers. In the past, major Internet service providers routinely exchanged traffic with other Internet service providers that met technical criteria on a "peering" basis, meaning that each Internet service provider accepted traffic routed to Internet addresses on their system from their "peers" on a reciprocal basis, without payment of compensation. However, since 1997 UUNET Technologies, Inc., the largest Internet service provider, has been greatly restricting the use of peering arrangements with other providers and has been imposing charges for accepting traffic from providers other than its "peers." Other major Internet service providers have adopted similar policies. We do not currently have any peering arrangements and cannot assure you that we will be able to negotiate "peer" status with any of the major nationwide Internet service providers in the future, or that we will be able to terminate traffic on Internet service providers' networks at favorable prices.

OUR OFFERING OF LONG DISTANCE SERVICES IS AFFECTED BY OUR ABILITY TO ESTABLISH EFFECTIVE RESALE AGREEMENTS

As part of our "one-stop shopping" offering of bundled telecommunications services to our customers, we offer long distance services. We have relied and will continue to rely on other carriers to provide transmission and termination services for all of our long distance traffic. We will continue to enter into resale agreements with long distance carriers to provide us with transmission services. Such agreements typically provide for the resale of long distance services on a per-minute basis and may contain minimum volume commitments. Negotiation of these agreements involves estimates of future supply and demand for transmission capacity as well as estimates of the calling pattern and traffic levels of our future customers. If we fail to meet our minimum volume commitments, we may be obligated to pay underutilization charges and if we underestimate our need for transmission capacity, we may be required to obtain capacity through more expensive means.

OUR PRINCIPAL COMPETITORS FOR LOCAL SERVICES, THE INCUMBENT LOCAL EXCHANGE CARRIERS, AND POTENTIAL ADDITIONAL COMPETITORS, HAVE ADVANTAGES THAT MAY ADVERSELY AFFECT OUR ABILITY TO COMPETE WITH THEM

The telecommunications industry is highly competitive. Many of our current and potential competitors in the local market have financial, technical, marketing, personnel and other resources, including brand name recognition, substantially greater than ours, as well as other competitive advantages over us. In each of the markets targeted by us, we will compete principally with the incumbent local exchange carrier serving that area and they enjoy advantages that may adversely affect our ability to compete with them. Incumbent local exchange carriers are established providers of local telephone services to all or virtually all telephone subscribers within their respective service areas. Incumbent local exchange carriers also have long-standing relationships with federal and state regulatory authorities. FCC and state administrative decisions and initiatives provide the incumbent local exchange carriers with pricing flexibility for their:

o private lines, which are private, dedicated telecommunications connections between customers;

o special access services, which are dedicated lines from a customer to a long distance company provided by the local phone company; and

o switched access services, which refers to the call connection provided by the local phone company's switch between a customer's phone and the long distance company's switch.

In addition,. with respect to competitive access services, such as special access services as opposed to switched access services, the FCC is considering allowing incumbent local exchange carriers increased pricing flexibility and deregulation for such access services either automatically or after certain competitive levels are reached. If the incumbent local exchange carriers are allowed by regulators to offer discounts to large customers through contract tariffs, engage in aggressive volume and term discount pricing practices for their customers, and/or seek to charge competitors excessive fees for interconnection to their networks, competitors such as us could be materially adversely affected. If future regulatory decisions afford the incumbent local exchange carriers increased pricing flexibility or other regulatory relief, such decisions could also have a material adverse effect on competitors such as us.

We also face, and expect to continue to face, competition in the local market from other current and potential market entrants, including long distance carriers seeking to enter, reenter or expand entry into the local exchange marketplace such as AT&T, MCI WorldCom and Sprint, and from other competitive local exchange carriers, resellers, competitive access providers, cable television companies, electric utilities, microwave carriers, wireless telephone system operators and private networks built by large end users. In addition, the development of new technologies could give rise to significant new competitors in the local market.

SIGNIFICANT COMPETITION IN PROVIDING LONG DISTANCE AND INTERNET SERVICES COULD REDUCE THE DEMAND FOR AND PROFITABILITY OF OUR SERVICES

We also face significant competition in providing long distance and Internet services. Many of these competitors have greater financial, technological, marketing, personnel and other resources than those available to us.

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The long distance telecommunications market has numerous entities competing for the same customers and a high average turnover rate, as customers frequently change long distance providers in response to the offering of lower rates or promotional incentives. Prices in the long distance market have declined significantly in recent years and are expected to continue to decline. We face competition from large carriers such as AT&T, MCI WorldCom and Sprint and many smaller long distance carriers. Other competitors are likely to include regional Bell operating companies providing long distance services outside of their local service area and, with the removal of regulatory barriers, long distance services within such local service areas, other competitive local exchange carriers, microwave and satellite carriers and private networks owned by large end users. We may also increasingly face competition from companies offering local and long distance data and voice services over the Internet. Such companies could enjoy a significant cost advantage because they do not currently pay many of the charges or fees that we have to pay. In addition, in June 1998, Sprint announced its intention to offer voice, data and video services over its nationwide asynchronous transfer mode network, which Sprint anticipates will significantly reduce its cost to provide such services. Sprint plans to bill its customers based upon the amount of traffic carried, irrespective of the time required to send the traffic or the traffic's destination.

The Internet services market is highly competitive and we expect that competition will continue to intensify. Our competitors in this market include Internet service providers, other telecommunications companies, online services providers and Internet software providers.

OUR NEED TO COMPLY WITH EXTENSIVE GOVERNMENT REGULATION CAN INCREASE OUR COSTS AND SLOW OUR GROWTH

Our networks and the provision of telecommunications services are subject to significant regulation at the federal, state and local levels. Delays in receiving required regulatory approvals or the enactment of new adverse regulation or regulatory requirements may slow our growth and have a material adverse effect upon us.

The FCC exercises jurisdiction over us with respect to interstate and international services. We must obtain, and have obtained through our subsidiary, Allegiance Telecom International, Inc., prior FCC authorization for installation and operation of international facilities and the provision, including by resale, of international long distance services. Additionally, we file publicly available documents detailing our services, equipment and pricing, also known as "tariffs," with the FCC for both international and domestic long-distance services.

State regulatory commissions exercise jurisdiction over us because we provide intrastate services. We are required to obtain regulatory authorization and/or file tariffs at state agencies in most of the states in which we operate. If and when we seek to build our own network segments, local authorities regulate our access to municipal rights-of-way. Constructing a network is also subject to numerous local regulations such as building codes and licensing. Such regulations vary on a city by city and county by county basis.

Regulators at both the federal and state level require us to pay various fees and assessments, file periodic reports, and comply with various rules regarding the contents of our bills, protection of subscriber privacy, and similar matters on an on-going basis.

We cannot assure you that the FCC or state commissions will grant required authority or refrain from taking action against us if we are found to have provided services without obtaining the necessary authorizations, or to have violated other requirements of their rules and orders. Regulators or others could challenge our compliance with applicable rules and orders. Such challenges could cause us to incur substantial legal and administrative expenses.

DEREGULATION OF THE TELECOMMUNICATIONS INDUSTRY INVOLVES UNCERTAINTIES, AND THE RESOLUTION OF THESE UNCERTAINTIES COULD ADVERSELY AFFECT OUR BUSINESS

The Telecommunications Act provides for a significant deregulation of the domestic telecommunications industry, including the local exchange, long distance and cable television industries. The Telecommunications Act remains subject to judicial review and additional FCC rulemaking, and thus it is difficult to predict what effect the legislation will have on us and our operations. There are currently many regulatory actions underway and being contemplated by federal and state authorities regarding interconnection pricing and other issues that could result in significant changes to the business conditions in the telecommunications industry. We cannot assure you that these changes will not have a material adverse effect upon us.

THE REGULATION OF INTERCONNECTION WITH INCUMBENT LOCAL EXCHANGE CARRIERS INVOLVES UNCERTAINTIES, AND THE RESOLUTION OF THESE UNCERTAINTIES COULD ADVERSELY AFFECT OUR BUSINESS

Although the incumbent local exchange carriers are required under the Telecommunications Act to unbundle and make available elements of their network and permit us to purchase only the origination and termination services that we need, thereby decreasing our operating expenses, such unbundling may not be done as quickly as we require and may be priced higher than we expect. This is important because we rely on the facilities of these other carriers to connect to our high capacity digital switches so that we can provide services to our customers. Our ability to obtain these interconnection agreements on favorable terms, and the time and expense involved in negotiating them, can be adversely affected by legal developments.

A recent Supreme Court decision vacated a FCC rule determining which network elements the incumbent local exchange carriers must provide to competitors on an unbundled basis. We expect that the FCC will conduct a rulemaking to adopt new standards for unbundling of network elements in conformance with this decision. The implementation of these and other FCC rules may lead to further litigation. This may complicate our interconnection negotiations, and may adversely affect our existing agreements and operations.

WE COULD LOSE REVENUE IF CALLS TO INTERNET SERVICE PROVIDERS ARE TREATED AS LONG DISTANCE INTERSTATE CALLS

We believe that other local exchange carriers should have to compensate us when their customers place calls to Internet service providers who are our customers. Most incumbent local exchange carriers disagree. Internet service providers are among our target customers, and decisions providing that other carriers do not have to compensate us for these calls could limit our ability to service this group of customers profitably.

For all other local calls, it is clear that the telecommunications company whose customer calls a customer of a second telecommunications company must compensate the second company. This is known as reciprocal compensation. This rule does not apply to long distance interstate calls and the FCC in its Declaratory Ruling of February 26, 1999, determined that Internet service provider traffic is interstate for jurisdictional purposes, but that its current rules neither require nor prohibit the payment of reciprocal compensation for such calls. In the absence of a federal rule, the FCC determined that state commissions have authority to interpret and enforce the reciprocal compensation provisions of existing interconnection agreements, and to determine the appropriate treatment of Internet service provider traffic in arbitrating new agreements.

THE REGULATION OF ACCESS CHARGES INVOLVES UNCERTAINTIES, AND THE RESOLUTION OF THESE UNCERTAINTIES COULD ADVERSELY AFFECT OUR BUSINESS

To the extent we provide long-distance, often referred to as "interexchange," telecommunications service, we are required to pay access charges to other local exchange carriers when we use the facilities of those companies to originate or terminate interexchange calls. As a competitive local exchange carrier, we also provide access services to other long distance service providers. The interstate access charges of incumbent local exchange carriers are subject to extensive regulation by the FCC, while those of competitive local exchange carriers are subject to a lesser degree of FCC regulation, but remain subject to the requirement that all charges be just, reasonable, and not unreasonably discriminatory. Disputes have arisen regarding the regulation of access charges and these may be resolved adversely to us.

The FCC has made major changes in the interstate access charge structure. The manner in which the FCC implements and monitors these increased pricing flexibility changes could have a material adverse effect on our ability to compete in providing interstate access services.

Some interexchange carriers, including AT&T, have also asked the FCC to take regulatory action to prevent competitive local exchange carriers from charging allegedly "excessive" access charges. Although no complaints have been filed against us, we do provide access service to interexchange carriers and we could be subject in the future to allegations that our charges for this service are unjust and unreasonable. In that event, we would have to provide the FCC with an explanation of how we set our rates and justify them as reasonable. We can give no assurance that the FCC will accept our rates as reasonable. If our rates are reduced by regulatory order, this could have a material adverse effect on our profitability.

IF WE DO NOT CONTINUALLY ADAPT TO TECHNOLOGICAL CHANGE, WE COULD LOSE CUSTOMERS AND MARKET SHARE

The telecommunications industry is subject to rapid and significant changes in technology, and we rely on outside vendors for the development of and access to new technology. The effect of technological changes on our business cannot be predicted. We believe our future success will depend, in part, on our ability to anticipate or adapt to such changes and to offer, on a timely basis, services that meet customer demands. We cannot assure you that we will obtain access to new technology on a timely basis or on satisfactory terms. Any failure by us to obtain new technology could cause us to lose customers and market share.

WE HAVE APPLIED FOR, BUT NOT YET RECEIVED, ASSURANCE FROM THE SEC REGARDING OUR STATUS UNDER THE INVESTMENT COMPANY ACT AND IF WE ARE SUBJECT TO THE INVESTMENT COMPANY ACT, IT COULD ADVERSELY AFFECT OUR FINANCING ACTIVITIES AND FINANCIAL RESULTS

Allegiance currently has substantial short-term investments, pending the deployment of our capital in the pursuit of building our business. This may result in Allegiance being deemed as an "investment company" under the Investment Company Act of 1940. This statute requires the registration of, and imposes various substantive restrictions on, certain companies that are, or hold themselves out as being, engaged primarily, or propose to engage primarily in, the business of investing, reinvesting or trading in securities, or that fail certain statistical tests regarding composition of assets and sources of income even though they do not intend to be primarily engaged in the businesses of investing, reinvesting, owning, holding or trading securities.

Allegiance is primarily engaged in a business other than investing, reinvesting, owning, holding or trading securities and, therefore, is not an investment company within the meaning of this statute. While we believe this means we are not an investment company within the meaning of that law, we have been able to also rely on a safe harbor in that law for certain transient or temporary investment companies. However, this exemption is only available to companies for a one-year period and that one-year period terminated in January 1999. We have applied to the SEC for a one-year exemptive order declaring that Allegiance is not an investment company and not required to register under this statute. We have not yet received such an order, and it is possible that we will not ultimately be successful in receiving such an order. We believe that if we are granted the exemption, under our current business plan we will have deployed a sufficient amount of capital by the end of the one-year period such that we would not then be deemed to be an investment company.

If we were required to register as an investment company under the Investment Company Act, we would become subject to substantial regulation with respect to our capital structure, management, operations, transactions with affiliated persons and other matters. To avoid having to register as an investment company, we may have to invest a portion of our liquid assets in cash and demand deposits instead of short-term securities. The extent to which we will have to do so will depend on the composition and value of our total assets at that time. Having to register as an investment company or having to invest a material portion of our liquid assets in cash and demand deposits to avoid such registration, could have a material adverse effect on our business, financial condition and results of operations.

FUTURE SALES OF OUR STOCK BY EXISTING STOCKHOLDERS MAY ADVERSELY AFFECT OUR STOCK PRICE

We currently have 50,360,866 shares of common stock outstanding. While certain of these shares are "restricted securities" under the federal securities laws, such shares are or will be eligible for sale subject to restrictions as to timing, manner, volume, notice and the availability of current public information regarding Allegiance. Sales of substantial amounts of stock in the public market, or the perception that sales could occur, could depress the prevailing market price for our stock. Sales may also make it more difficult for us to sell equity securities or equity-related securities in the future at a time and price that we deem appropriate.

ANTI-TAKEOVER PROVISIONS IN ALLEGIANCE'S CHARTER AND BYLAWS COULD LIMIT OUR SHARE PRICE AND DELAY A CHANGE OF MANAGEMENT

Our certificate of incorporation and by-laws contain provisions that could make it more difficult or even prevent a third party from acquiring Allegiance without the approval of our incumbent board of directors.

ITEM 2. PROPERTIES

Allegiance owns or leases, in its operating territories, telephone property which includes:

- owning switches
- leasing high capacity digital lines that interconnect Allegiance's network with ILEC networks;
- leasing high capacity digital lines that connect Allegiance's switching equipment to Allegiance transmission equipment located in ILEC central offices;
- leasing local loop lines which connect Allegiance's customers to Allegiance's network; and
- leasing space in ILEC central offices for collocating Allegiance transmission equipment.

Allegiance is headquartered in Dallas, Texas and leases offices and space in a number of locations, primarily for sales offices and network equipment installations. The table below lists Allegiance's current leased facilities:

LOCATION	LEASE EXPIRATION	APPROXIMATE SQUARE FOOTAGE
Dallas, TX	February 2008	76,000
Atlanta, GA	February 2003	7,400
Atlanta, GA	November 2001	7,300
Boston, MA	September 2003	12,000
Boston, MA	September 2008	18,000
Chicago, IL	March 2009	11,000
Chicago, IL	July 2008	14,000
Fort Worth, TX	June 2003	3,900
Houston, TX	December 2005	11,700
Houston, TX	November 2008	18,000
Los Angeles, CA	June 2008	11,700
Los Angeles, CA	June 2008	14,585
Newport, CA	April 2006	7,800
New York, NY	August 2006	8,700
New York, NY	March 2008	19,500
New York, NY	June 2008	12,400
Oakland, CA	December 2006	2,000
Philadelphia, PA	April 2002	8,900
Philadelphia, PA	October 2008	18,000
San Diego, CA	March 2008	14,000
San Francisco, CA	April 2002	8,100
San Francisco, CA	June 2008	16,000
San Jose, CA	February 2004	4,500
Washington, DC	November 2008	15,000
Washington, DC	November 2006	8,200
Westchester, IL	January 2001	10,700
Westchester, IL	April 2001	5,700

Allegiance believes that its leased facilities are adequate to meet its current needs in the markets in which it has begun to deploy networks, and that additional facilities are available to meet its development and expansion needs in existing and projected target markets for the foreseeable future.

ITEM 3. LEGAL PROCEEDINGS

Allegiance is not party to any legal proceeding that Allegiance believes would, individually or in the aggregate, have a material adverse effect on Allegiance's financial condition or results of operations.

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

Allegiance did not submit any matter to a vote of its stockholders during the fourth quarter of 1998.

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ITEM 4A. EXECUTIVE OFFICERS OF ALLEGIANCE

The following sets forth certain information regarding Allegiance's executive officers. Allegiance's executive officers are elected annually by the board of directors at its first meeting held after each annual meeting of stockholders or as soon thereafter as convenient.

NAME	AGE	POSITION(S)
Royce J. Holland	50	Chairman of the Board and Chief Executive Officer
C. Daniel Yost	50	President and Chief Operating Officer and Director
Thomas M. Lord	42	Executive Vice President of Corporate Development, Chief Financial Officer, and Director
John J. Callahan	49	Senior Vice President of Sales and Marketing and Director
Dana A. Crowne	38	Senior Vice President and Chief Engineer
Stephen N. Holland	47	Senior Vice President and Chief Information Officer
Patricia E. Koide	50	Senior Vice President of Human Resources, Real Estate, Training, Facilities and Administration
Gregg A. Long	45	Senior Vice President of Development and Regulatory
Mark B. Tresnowski	39	Senior Vice President, General Counsel and Secretary
Anthony J. Parella	39	National Vice President of Field Sales

Royce J. Holland, Allegiance's Chairman of the Board and Chief Executive Officer, has more than 25 years of experience in the telecommunications, independent power and engineering/construction industries. Prior to founding Allegiance in April 1997, Mr. Holland was one of several co-founders of MFS Communications, where he served as President and Chief Operating Officer from April 1990 until September 1996 and as Vice Chairman from September 1996 to February 1997. In January 1993, Mr. Holland was appointed by President George Bush to the National Security Telecommunications Advisory Committee. Mr. Holland was recently named Chairman of the Association for Local Telecommunications Services, the industry trade organization for the competitive telephone sector. Mr. Holland also presently serves on the board of directors of CSG Systems, a publicly held billing services company. Mr. Holland's brother, Stephen N. Holland, is employed as Allegiance's Senior Vice President and Chief Information Officer.

C. Daniel Yost, who joined Allegiance as President and Chief Operating Officer in February 1998, was elected to Allegiance's board of directors in March 1998. Mr. Yost has more than 26 years of experience in the telecommunications industry. From July 1997 until he joined Allegiance, Mr. Yost was the President and Chief Operating Officer for U.S. Operations of Netcom On-Line Communications Services, Inc., a leading Internet service provider. Mr. Yost served as the President, Southwest Region of AT&T Wireless Services, Inc. from June 1994 to July 1997. Prior to that, from July 1991 to June 1994, Mr. Yost was the President, Southwest Region of McCaw Cellular Communications/LIN Broadcasting.

Thomas M. Lord, a co-founder and director of Allegiance and its Executive Vice President of Corporate Development and Chief Financial Officer, is responsible for overseeing Allegiance's mergers and acquisitions, corporate finance and investor relations functions. Mr. Lord is an 18-year veteran in investment banking, securities research and portfolio management, including serving as a managing director of Bear, Stearns & Co. Inc. from January 1986 to December 1996. In the five-year period ending December 1996, Mr. Lord oversaw 43 different transactions valued in excess of $6.2 billion for the telecommunications, information services and technology industries.

John J. Callahan, who joined Allegiance as Senior Vice President of Sales and Marketing in December 1997, has more than 18 years of experience in the telecommunications industry. Most recently, Mr. Callahan was President of the Western Division for MFS Communications from December 1991 to November 1997, where he was responsible for the company's sales and operations in Arizona, California, Georgia, Florida, Illinois, Michigan, Missouri, Ohio, Oregon, Texas and Washington. Prior to joining MFS Communications, Mr. Callahan was Vice President and General Manager, Southwest Division for Sprint. Mr. Callahan also held sales positions with Data Switch and North American Telecom. Mr. Callahan was elected to Allegiance's board of directors in March 1998.

Dana A. Crowne became Allegiance's Senior Vice President and Chief Engineer in August 1997. Prior to joining Allegiance, Mr. Crowne held various management positions at MFS Communications from the time of its founding in 1988, where his responsibilities included providing engineering support and overseeing budgets for the construction of MFS Communications' networks. Mr. Crowne ultimately became Vice President, Network Optimization for MFS Communications from January 1996 to May 1997 and managed the company's network expenses and planning and its domestic engineering functions. Prior to joining MFS Communications, Mr. Crowne designed and installed fiber optic transmission systems for Morrison-Knudsen and served as a consultant on the construction of private telecommunications networks with JW Reed and Associates.

Stephen N. Holland joined Allegiance as its Senior Vice President and Chief Information Officer in September 1997. Prior to that time, Mr. Holland held several senior level positions involving management of or consulting on information systems, accounting, taxation and finance. Mr. Holland's experience includes serving as Practice Manager and Information Technology Consultant for Oracle Corporation from June 1995 to September 1997, as Chief Financial Officer of Petrosurance Casualty Co. from September 1992 to June 1995, as Manager of Business Development for Electronic Data Systems, and as a partner of Price Waterhouse. Mr. Holland's brother, Royce J. Holland, presently serves as Allegiance's Chairman of the Board and Chief Executive Officer.

Patricia E. Koide has been Allegiance's Senior Vice President of Human Resources, Real Estate, Training Facilities and Administration since August 1997. Before then, Ms. Koide was Vice President of Corporate Services, Facilities and Administration for WorldCom from March 1997 to August 1997. Ms. Koide also held various management positions within MFS Communications and its subsidiaries since 1989, including Senior Vice President of Facilities, Administration and Purchasing for MFS Communications North America from 1996 to 1997, Senior Vice President of Human Resources, Facilities and Administration for MFS Communications Telecom from 1994 to 1996, and Vice President of Human Resources and Administration for MFS Communications North America from 1989 to 1993. Prior to MFS Communications, Ms. Koide was with Sprint for eight years where she managed the company's human resources, real estate and facilities for the Midwest.

Gregg A. Long, who became Allegiance's Senior Vice President of Regulatory and Development in September 1997, spent 11 years at Destec Energy, Inc. as Project Development Manager C Partnership Vice President and Director. In that position, he was responsible for the development of gas-fired power plants from conceptual stages through project financing. Prior to joining Destec, Mr. Long was Manager of Project Finance at Morrison-Knudsen, where he was responsible for analyzing and arranging finance packages for various industrial, mining and civil projects and also served as financial consultant and analyst.

Mark B. Tresnowski became Allegiance's Senior Vice President and General Counsel in February 1999. Mr. Tresnowski has been Allegiance's Secretary since September 1997. Mr. Tresnowski practiced law at Kirkland & Ellis for 13 years and was a partner of that firm from October 1992 to January 1999. In private practice, Mr. Tresnowski specialized in private and public financings, mergers and acquisitions and securities law.

Anthony J. Parella, who joined Allegiance as its Regional Vice President -- Central Division in August 1997 and became its National Vice President of Field Sales in August 1998, has more than 10 years of experience in the telecommunications industry. Prior to joining Allegiance, Mr. Parella was Vice President and General Manager for MFS Intelenet, Inc., an operating unit of MFS Communications, from February 1994 to January 1997, where he was responsible for the company's sales and operations in Texas. Mr. Parella also served as Director of Commercial Sales for Sprint from 1991 to January 1994.

PART II

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

MARKET INFORMATION

Allegiance's common stock is listed on the Nasdaq National Market. Allegiance's ticker symbol is "ALGX." Allegiance completed the initial public offering of its common stock in July 1998. Prior to July 1, 1998, no established public trading market for the common stock existed.

The following table sets forth on a per share basis, the high and low sale prices per share for our common stock as reported on the Nasdaq National Market for the periods indicated:

	HIGH	LOW
Year ended December 31, 1998:		
Third quarter (from July 1, 1998)	$ 15.688	$ 6.250
Fourth quarter	$ 13.375	$ 5.000
Year ended December 31, 1999:		
First quarter (through March 24, 1999)	$ 31.000	$ 11.563

STOCKHOLDERS

There were approximately 128 owners of record of Allegiance common stock as of March 24, 1999. This number excludes stockholders whose stock is held in nominee or street name by brokers and Allegiance believes that it has a significantly larger number of beneficial holders of common stock. A recent reported last sale price of our common stock on the Nasdaq National Market is set forth on the front cover of this report.

DIVIDENDS

We do not anticipate paying any cash dividends in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board of directors and will be dependent upon then existing conditions, including our financial condition, results of operations, contractual restrictions, capital requirements, business prospects, and other factors our board of directors deems relevant. In addition, our current financing arrangements effectively prohibit us from paying cash dividends for the foreseeable future.

RECENT SALES OF UNREGISTERED SECURITIES

On February 25, 1998, Allegiance issued:

(a) 71.25 shares of redeemable convertible preferred stock to Richard Fields for an aggregate initial purchase price of $37,500; these shares now represent 30,374 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering;

(b) 95 shares of redeemable convertible preferred stock to Roger Curry for an aggregate initial purchase price of $50,000; these shares now represent 40,498 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering;

(c) 23.75 shares of redeemable convertible preferred stock to Northwestern University for an aggregate initial purchase price of $12,500; these shares now represent 10,125 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering;

(d) 237.5 shares of redeemable convertible preferred stock to MKW Partners, L.P. for an aggregate initial purchase price of $125,001; these shares now represent 101,245 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering;

(e) 47.5 shares of redeemable convertible preferred stock to Tom Shattan for an aggregate initial purchase price of $25,000; these shares now represent 20,249 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering;

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(f) 28.5 shares of redeemable convertible preferred stock to Greg Mendel for an aggregate initial purchase price of $15,000; these shares now represent 12,149 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering; and

(g) 19 shares of redeemable convertible preferred stock to Kevin Fechtmeyer for an aggregate initial purchase price of $10,000; these shares now represent 8,100 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering.

On March 13, 1998, Allegiance issued 118.75 shares of redeemable convertible preferred stock to Charles Ross Partners, LLC for an aggregate initial purchase price of $62,500. These shares now represent 50,623 shares of common stock after giving effect to the conversion of such preferred stock into common stock and stock split in connection with the initial public offering.

The above-described transactions were exempt from registration under the Securities Act under Section 4(2) of the Securities Act, as transactions not involving any public offering.

On February 3, 1998, Allegiance issued 445,000 units, with each unit consisting of one 11 3/4% Senior Discount Note due 2008 and one redeemable warrant to purchase .0034224719 shares of Allegiance's common stock. Allegiance received approximately $240.7 million of net proceeds, after deducting underwriting discounts and commissions of approximately $8.75 million and other expenses payable by Allegiance of approximately $1.0 million, from the issuance of the units. Such units were issued to:

(a) "qualified institutional buyers" (as defined in Rule 144A of the Securities Act),

(b) other institutional "accredited investors" (as defined in Rule 501(a) of the Securities Act), and

(c) outside the United States in compliance with Regulation S under the Securities Act,

and therefore, the issuance of such units was exempt from registration under the Securities Act. Morgan Stanley & Co. Incorporated, Salomon Brothers Inc, Bear, Stearns & Co. Inc. and Donaldson, Lufkin & Jenrette Securities Corporation were the initial purchasers of the units. As a result of Allegiance's 426.2953905-for-one stock split in connection with its initial public offering, each warrant is exercisable to purchase 1.45898399509 shares of common stock at an exercise price of $.01 per share, subject to anti-dilution adjustments set forth in the warrant agreement governing the warrants. All of these warrants are currently exercisable.

ITEM 6. SELECTED FINANCIAL DATA

The information required by this Item 6 is incorporated in this report by reference from the section titled "Selected Financial Data" of our annual report to stockholders for the fiscal year ended December 31, 1998 (the "annual report").

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

The information required by this Item 7 is incorporated in this report by reference from the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our annual report.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Allegiance's investment policy is limited by its existing bond indentures. Allegiance is restricted to investing in financial instruments with a maturity of one year or less. The indentures require investments in high quality instruments, such as obligations of the U.S. Government or any agency thereof guaranteed by the United States of America, money market deposits, and commercial paper with a rating of A1/P1.

Allegiance is thus exposed to market risk related to changes in short-term U.S. interest rates. Allegiance manages these risks by closely monitoring market rates and the duration of its investments. Allegiance does not enter into financial or commodity investments for speculation or trading purposes and is not a party to any financial or commodity derivatives.

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Interest income earned on Allegiance's investment portfolio is affected by changes in short-term U.S. interest rates. Allegiance believes that it is not exposed to significant changes in fair value because of its conservative investment strategy. However, the estimated interest income for the calendar year 1999, based on the average 1998 earned rate on investments, is $13.6 million and assuming a 100 basis point drop in the average rate, Allegiance would be exposed to a $2.5 million reduction in interest income for the year. The following table illustrates this impact on a quarterly basis:

	QUARTER ENDING				
	MARCH 1999	JUNE 1999	SEPTEMBER 1999	DECEMBER 1999	TOTAL
			($$ IN MILLIONS)		
Estimated Average Outstanding Balance	$ 367.4	$ 290.7	$ 213.9	$ 131.8	
Estimated Interest Earned at Estimated Rate of 5.4% at December 31, 1998	$ 5.0	$ 3.9	$ 2.9	$ 1.8	$ 13.6
Estimated Impact of Interest Rate drop	$ 0.9	$ 0.7	$ 0.5	$ 0.3	$ 2.5

Allegiance has outstanding long term, fixed rate notes, not subject to interest rate fluctuations.

ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The information required by this Item 8 is incorporated in this report by reference from the financial statements contained in our annual report, except for the financial statement schedules which are included in Item 14 of this report. For a list of financial statements filed as part of this report, see Item 14 of this report.

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

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF ALLEGIANCE

The information required by this Item 10 regarding Allegiance's directors is incorporated in this report by reference from certain sections of our definitive proxy statement for the annual meeting of stockholders for the fiscal year ended December 31, 1998, which will be filed with the SEC no later than April 30, 1999 (the "proxy statement"). You will find our response to this Item 10 in the sections titled "Who Are Allegiance's Directors and Officers?" and "About the Board of Directors and its Committees" of our proxy statement.

Information required by this Item 10 regarding the executive officers of Allegiance is included in Item 4A of Part I of this report as permitted by Instruction 3 to Item 401(b) of Regulation S-K.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item 11 is incorporated in this report by reference from the sections titled "Compensation of Directors and Executive Officers," "Compensation Committee Interlocks and Insider Participation" and "Executive Agreements" of our proxy statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item 12 is incorporated in this report by reference from the section titled "Security Ownership of Certain Beneficial Owners and Management" of our proxy statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this Item 13 is incorporated in this report by reference from the section titled "Certain Relationships and Related Transactions" of our proxy statement.

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PART IV

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

(a)(1) Financial Statements (the following financial information from our annual report is incorporated by reference into Part II of this report):

Report of Independent Public Accountants

Consolidated Balance Sheets as of December 31, 1998, and December 31, 1997

Consolidated Statements of Operations for the year ended December 31, 1998, and for the Period from Inception (April 22, 1997) through December 31, 1997

Consolidated Statements of Stockholders' Equity (Deficit) for the year ended December 31, 1998, and for the Period from Inception (April 22, 1997) through December 31, 1997

Consolidated Statements of Cash Flows for the year ended December 31, 1998, and for the Period from Inception (April 22, 1997) through December 31, 1997

Notes to Consolidated Financial Statements

(a)(2) Financial Statement Schedules:

S-I Report of Independent Public Accountants on Financial Statement Schedule

S-II Valuation and Qualifying Accounts for the years ended December 31, 1997 and 1998

(a)(3) The exhibits filed in response to Item 601 of Regulation S-K are listed in the Exhibit Index starting on page E-1 of this report.

(b) Reports on Form 8-K

There were no reports filed during the three months ended December 31, 1998.

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SIGNATURES

According to the requirements of the Securities Exchange act of 1934, Allegiance Telecom, Inc. has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on March 29, 1999.

ALLEGIANCE TELECOM, INC.

By /s/ ROYCE J. HOLLAND -- Royce J. Holland, Chairman of the Board and Chief Executive Officer

According to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities indicated on March 29, 1999.

/s/ ROYCE J. HOLLAND -- Royce J. Holland	Chairman of the Board and Chief Executive Officer (Principal Executive Officer)
/s/ C. DANIEL YOST -- C. Daniel Yost	President, Chief Operating Officer, and Director
/s/ THOMAS M. LORD -- Thomas M. Lord	Executive Vice President, Chief Financial Officer, and Director (Principal Financial Officer)
/s/ DENNIS M. MAUNDER -- Dennis M. Maunder	Vice President and Controller (Principal Accounting Officer)
/s/ JOHN J. CALLAHAN -- John J. Callahan	Senior Vice President of Sales and Marketing, and Director
/s/ PAUL D. CARBERY -- Paul D. Carbery	Director
/s/ JAMES E. CRAWFORD, III -- James E. Crawford, III	Director
/s/ JOHN B. EHRENKRANZ -- John B. Ehrenkranz	Director
/s/ PAUL J. FINNEGAN -- Paul J. Finnegan	Director
/s/ RICHARD D. FRISBIE -- Richard D. Frisbie	Director
/s/ ALAN E. GOLDBERG -- Alan E. Goldberg	Director
/s/ REED E. HUNDT -- Reed E. Hundt	Director
/s/ JAMES N. PERRY, JR. --	Director

James N. Perry, Jr.

ALLEGIANCE TELECOM, INC.

SCHEDULE I — REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS ON FINANCIAL STATEMENT SCHEDULE

To the Board of Directors and Stockholders of Allegiance Telecom, Inc.:

We have audited, in accordance with generally accepted auditing standards, the consolidated balance sheets of Allegiance Telecom, Inc. and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity (deficit) and cash flows for the year ended December 31, 1998, and for the period from inception (April 22, 1997), to December 31, 1997, incorporated by reference in this Form 10-K and have issued our report thereon dated February 3, 1999. These consolidated financial statements and the schedule referred to below are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

Our audits were made for the purpose of forming an opinion on the basic consolidated financial statements taken as a whole. Schedule II — Valuation and Qualifying Accounts is not a required part of the basic consolidated financial statements but is supplementary information required by the Securities and Exchange Commission. This information has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic consolidated financial statements taken as a whole.

ARTHUR ANDERSEN LLP

Dallas, Texas,
February 3, 1999

ALLEGIANCE TELECOM, INC.

SCHEDULE II — VALUATION AND QUALIFYING ACCOUNTS
For the Years Ended December 31, 1997 and 1998
(Dollars in Thousands)

Description	Balance at Beginning of Period	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions	Balance at End of Period
Allowance for Doubtful Accounts					
Year Ended December 31, 1998	$ —	$ 649.8	$ —	$ (72.6)	$ 577.2
From period of inception (April 22, 1997) to December 31, 1997	$ —	$ —	$ —	$ —	$ —

EXHIBIT INDEX

EXHIBIT NO.	DESCRIPTION
1.1	Form of Underwriting Agreement (Exhibit 1.1 to Allegiance's Registration Statement on Form S-1, Registration No. 333-53479 (the "Form S-1 Registration Statement")).
3.1	Amended and Restated Certificate of Incorporation (Exhibit 3.1 to Allegiance's Form 10-Q for the period ended June 30, 1998).
*3.2	Certificate of Correction to Amended and Restated Certificate of Incorporation.
3.3	Amended and Restated By-Laws (Exhibit 3.2 to Allegiance's Form 10-Q for the period ended June 30, 1998).
4.1	Indenture, dated as of July 7, 1998, by and between Allegiance and The Bank of New York, as trustee (including the Form of Notes) (Exhibit 4.1 to Allegiance's Registration Statement on Form S-1, Registration No. 333-69543).
4.2	Indenture, dated as of February 3, 1998, by and between Allegiance and The Bank of New York, as trustee (Exhibit 4.2 to Allegiance's Registration Statement on Form S-4, Registration No. 333-49013 (the "Form S-4 Registration Statement")).
4.3	Form of 11 3/4% Senior Discount Notes (Exhibit 4.3 to the Form S-4 Registration Statement).
4.4	Collateral Pledge and Security Agreement, dated as of July 7, 1998, by and between Allegiance and The Bank of New York, as trustee (Exhibit 4.4 to Allegiance Telecom, Inc.'s Registration Statement on Form S-1, Registration No. 333-69543).
10.1	Stock Purchase Agreement, dated August 13, 1997, between Allegiance LLC and Allegiance (Exhibit 10.1 to the Form S-4 Registration Statement).
10.2	Securityholders Agreement, dated August 13, 1997, among Allegiance LLC, the Fund Investors, the Management Investors and Allegiance (Exhibit 10.2 to the Form S-4 Registration Statement).
10.3	Registration Agreement, dated August 13, 1997, among the Fund Investors, the Management Investors and Allegiance (Exhibit 10.3 to the Form S-4 Registration Statement).
10.4	Warrant Registration Rights Agreement, dated as of January 29, 1998, by and among Allegiance and Morgan Stanley & Co. Incorporated, Salomon Brothers Inc, Bear, Stearns & Co. Inc. and Donaldson, Lufkin & Jenrette Securities Corporation, as initial purchasers of the 11 3/4% Senior Discount Notes (Exhibit 10.11 to the Form S-4 Registration Statement).
+10.5	Allegiance Telecom, Inc. 1997 Nonqualified Stock Option Plan (Exhibit 10.4 to the Form S-4 Registration Statement).
+10.6	Allegiance Telecom, Inc. 1998 Stock Incentive Plan (Exhibit 10.6 to the Form S-1 Registration Statement).
*+10.7	First Amendment to the Allegiance Telecom, Inc. 1998 Stock Incentive Plan.
+10.8	Executive Purchase Agreement, dated August 13, 1997, among Allegiance LLC, Allegiance and Royce J. Holland (Exhibit 10.5 to the Form S-4 Registration Statement).
+10.9	Executive Purchase Agreement, dated August 13, 1997, among Allegiance LLC, Allegiance and Thomas M. Lord (Exhibit 10.6 to the Form S-4 Registration Statement).
+10.10	Executive Purchase Agreement, dated January 28, 1998, among Allegiance LLC, Allegiance and C. Daniel Yost (Exhibit 10.7 to the Form S-4 Registration Statement).
+10.11	Form of Executive Purchase Agreement among Allegiance LLC, Allegiance and each of the other Management Investors (Exhibit 10.8 to the Form S-4 Registration Statement).
10.12	Warrant Agreement, dated February 3, 1998, by and between Allegiance and The Bank of New York, as Warrant Agent (including the form of the Warrant Certificate) (Exhibit 10.9 to the Form S-4 Registration Statement).
10.13	General Agreement, dated October 16, 1997, as amended, between Allegiance and Lucent Technologies Inc. (Exhibit 10.10 to the Form S-4 Registration Statement).

10.14	Form of Indemnification Agreement by and between Allegiance and its directors and officers (Exhibit 10.13 to the Form S-1 Registration Statement).
*11.1	Statement Regarding Computation of Per Share Earnings (Loss) for the year ended December 31, 1998.
*11.2	Statement Regarding Computation of Per Share Earnings (Loss) for the period from inception (April 22, 1997) through December 31, 1997.
*13.1	Portions of Allegiance's Annual Report to Stockholders for the year ended December 31, 1998.
*21.1	Subsidiaries of Allegiance.

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*23.1	Consent of Arthur Andersen LLP.
*27.1	Financial Data Schedule for the year ended December 31, 1998.
27.2	Financial Data Schedule for the period from inception (April 22, 1997) through December 31, 1997 (incorporated by reference to Exhibit 27.2 to the Form S-4 Registration Statement).

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* Filed as part of this report. + Management contract or compensatory plan or arrangement filed as an exhibit to this report pursuant to Items 14(a) and 14(c) of Form 10-K.

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	As of December 31,	
	1998	1997
Balance Sheet Data:		
Cash and cash equivalents	$ 262,501.7	$ 5,726.4
Short-term investments	143,389.7	--
Short-term investments, restricted(1)	25,542.8	--
Working capital(2)	366,162.7	2,046.2
Property and equipment, net of accumulated depreciation and amortization	144,860.0	23,899.9
Long-term investments, restricted(1)	36,699.2	--
Total assets	637,874.3	30,047.0
Long-term debt	471,652.1	--
Redeemable cumulative convertible preferred stock	--	33,409.4
Redeemable warrants	8,634.1	--
Stockholders' equity (deficit)	110,429.6	(7,292.1)
Other Financial Data:		
EBITDA(3)	$ (45,832.0)	$ (3,576.7)
Net cash used in operating activities	(17,269.8)	(1,942.9)
Net cash used in investing activities	(319,170.4)	(21,926.0)
Net cash provided by financing activities	593,215.5	29,595.3
Capital expenditures	(113,538.7)	(21,926.0)

(1) Reflects the purchase of U.S. government securities, which have been placed in a pledge account, to fund the first three years' interest payments on the 12 7/8% Senior Notes due 2008, the first semiannual installment of which was paid in November 1998. The securities are stated at their accreted value, which approximates fair value, and are classified as short-term and long-term based upon the maturity dates of each of the securities at the balance sheet date.

(2) Working capital was calculated as total current assets, less restricted short-term investments, less total current liabilities.

(3) EBITDA consists of earnings before interest, income taxes, depreciation and amortization, management ownership allocation charge and non-cash deferred compensation. While not a measure under generally accepted accounting principles, EBITDA is a measure commonly used in the telecommunications industry and is presented to assist in understanding the Company's operating results. Although EBITDA should not be construed as a substitute for operating income (loss) determined in accordance with

generally accepted accounting principles, it is included herein to provide additional information with respect to the ability of the Company to meet future debt service, capital expenditure and working capital requirements. The calculation of EBITDA does not include the commitments of the Company for capital expenditures and payment of debt and should not be deemed to represent funds available to the Company. See "Management's Discussion & Analysis of Financial Condition & Results of Operations" for a discussion of the financial operations and liquidity of the Company as determined in accordance with generally accepted accounting principles.

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

Overview

Allegiance is a competitive local exchange carrier (CLEC), seeking to be a premier provider of telecommunications services to business, government and other institutional users in major metropolitan areas across the United States. Allegiance offers an integrated set of telecommunications products and services including local exchange, local access, domestic and international long distance, data and a full suite of Internet services. Its principal competitors are incumbent local exchange carriers (ILECs), such as the regional Bell operating companies and GTE Corporation operating units.

Allegiance is developing its networks throughout the U.S., using what it refers to as a "Smart Build" approach. In contrast to the traditional network build-out strategy under which carriers install their own telecommunications switch in each market and then construct their own fiber optic networks to reach customers, Allegiance installs its own switch in each market but then leases other elements of the network from the ILECs. The Smart Build strategy specifically involves:

o leasing existing ILEC copper wire connections throughout a local market area, also called the "local loop," which connect customers to the central offices, or "hubs," of an ILEC network; and

o installing, or physically locating, transmission equipment in these central offices to route customer traffic through them to Allegiance's own switch.

Locating equipment at ILEC facilities, also known as "collocation," is central to the success of the Smart Build strategy. By collocating, Allegiance has the ability to lease, on a monthly or long-term basis, local loop and other network elements owned by the ILEC. This enables Allegiance to reach a wide range of customers without having to build network connections to each one of them.

Management believes that the Smart Build approach offers a number of competitive advantages over the traditional build-out strategy by allowing Allegiance to:

o accelerate market entry by nine to 18 months by eliminating or at least deferring the need for city franchises, rights-of-way and building access;

o reduce initial capital expenditures in each market, allowing Allegiance to focus its initial capital resources on the critical areas of sales, marketing, and operations support systems, instead of on constructing extensive fiber optic networks to each customer;

o improve return on capital by generating revenue with a smaller capital investment;

o defer capital expenditures for network assets to the time when revenue generated by customer demand is available to finance such expenditures; and

o address attractive service areas selectively throughout target markets and not just in those areas where Allegiance owns network transmission facilities.

Once traffic volume justifies further investment, Allegiance may then construct its own fiber network or lease unused fiber to which

Allegiance adds its own electronic transmission equipment. This unused fiber is known as "dark fiber," because no light is transmitted through it while it is unused. Allegiance believes that dark fiber is readily available in most major markets.

Allegiance has rapidly deployed its networks since commencing service in December 1997 and was operating in nine markets across the U.S. as of the end of 1998, and 11 as of March 15, 1999. Allegiance has had significant success in selling its services to customers, with approximately 86,500 lines sold during 1998. The table below provides selected key operational data:

	As of December 31,	
	1998	1997
Markets served	9	--
Number of switches deployed	7	--
Central office collocations	101	--
Addressable market (business lines)	3.6 million	--
Lines sold	86,500	20
Lines installed	47,700	9
Sales force employees	295	--
Total employees	649	40

Allegiance does not begin to develop a new market until it has raised the capital that it projects to be necessary to build its network and operate that market to the point at which operating cash flow from the market is sufficient to fund such market's operating costs and capital expenditures.

Results of Operations

Allegiance commenced operations in August 1997. During the period from August to December 1997, Allegiance did not sell any services or open any markets. Instead, substantial effort was devoted to developing business plans, initiating applications for governmental authorizations, hiring management and other key personnel, working on the design and development of local exchange telephone networks and operations support systems, acquiring equipment and facilities, and negotiating interconnection agreements. Allegiance initiated service by buying phone lines at wholesale prices and then reselling them to nine "beta" customers in Dallas during December 1997, generating only $400 of revenue for that period. Given that Allegiance has significantly increased its customer base and geographic markets from the commencement of operations in Dallas during 1997, comparisons of 1998 results with those of 1997 are not meaningful.

Allegiance first provided service using its own switch and transmission equipment in April 1998 to customers in New York City. Throughout the remainder of 1998, it initiated facilities-based services in Atlanta, Boston, Chicago, Dallas, Fort Worth, Los Angeles, Oakland and San Francisco. In January 1999, Allegiance announced that it was operational in Philadelphia. In March 1999, Allegiance announced that it was operational in Washington, D.C., including suburban Maryland and Virginia. Allegiance expects to become operational in San Jose during the first quarter of 1999. Allegiance plans to open five additional markets during 1999 for which it has already raised the necessary capital.

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Although Allegiance initiated resale services in Dallas in 1997, Allegiance sales teams have focused their efforts almost exclusively on selling services that require the use of Allegiance facilities. Allegiance earns significantly higher margins by providing facilities-based services instead of resale services. During the fourth quarter of 1998, facilities-based lines represented 91% of all lines sold and 83% of all lines installed, as compared to 86% and 73% for the third quarter of 1998 and 51% and 17% for the second quarter of 1998, respectively. For the full year, 67,100 facilities-based lines were sold, and 30,500 of those were installed. Resale lines sold during 1998 totaled 19,400, of which 17,200 were installed. Allegiance continues to emphasize the sale of facilities-based services and lines. We estimate that the proportion of customer lines for which we simply resell service provided by other carriers will continue to decline to the point that, eventually, no more than 5% of all lines Allegiance sells will be resale lines.

During 1998, Allegiance generated $9.8 million of revenue. The majority, $6.9 million, was local service revenue consisting of:

- the monthly recurring charge for basic service;
- usage-based charges for local calls in certain markets;
- charges for vertical services, such as call waiting and call forwarding; and
- to a lesser extent, non-recurring charges, such as charges for additional lines for an existing customer.

Access charges, which we earn by connecting Allegiance local service customers to their selected long distance carriers for outbound calls or by delivering inbound long distance traffic to Allegiance local service customers, accounted for $2.2 million of Allegiance's 1998 revenues. Approximately 20% of Allegiance's local service customers have chosen Allegiance as their long distance carrier. Long distance revenues during 1998 amounted to $.7 million. All other sources of revenue accounted for approximately $10,000 during 1998.

During 1998, Allegiance recognized an insignificant amount of revenue from "reciprocal compensation" generated by having customers of other local exchange carriers calling Internet service providers that are Allegiance customers. Allegiance had no revenue from reciprocal compensation during 1997. Given the uncertainty as to whether reciprocal compensation should be payable in connection with calls to Internet service providers, Allegiance recognizes such revenue only when realization of it is certain, which in most cases will be upon receipt of cash.

ILECs around the country have been contesting whether the obligation to pay reciprocal compensation to CLECs should apply to local telephone calls from an ILEC's customers to Internet service providers served by CLECs. The ILECs claim that this traffic is interstate in nature and therefore should be exempt from compensation arrangements applicable to local, intrastate calls. CLECs have contended that the interconnection agreements provide no exception for local calls to Internet service providers and reciprocal compensation is therefore applicable. Currently, over 25 state commissions and several federal and state courts have ruled that reciprocal compensation arrangements do apply to calls to Internet service providers, and no jurisdiction has ruled to the contrary. Certain of these rulings are subject to appeal. Additional disputes over the appropriate treatment of Internet service provider traffic are pending in other states. On February 26, 1999, the FCC released a Declaratory Ruling determining that Internet service provider traffic is interstate for jurisdictional purposes, but that its current rules neither require nor prohibit the payment of reciprocal compensation for such calls. In the absence of a federal rule, the FCC determined that state commissions have authority to interpret and enforce the reciprocal compensation provisions of existing interconnection agreements, and to determine the appropriate treatment of Internet service provider traffic in arbitrating new agreements. The FCC also requested comment on alternative federal rules to govern compensation for such calls in the future. In response to the FCC ruling, some regional Bell operating companies have asked state commissions to reopen previous decisions requiring the payment of reciprocal compensation on Internet service provider calls. Allegiance anticipates that Internet service providers will be among its target customers, and adverse decisions in state proceedings could limit its ability to service this group of customers profitably.

The revenue yield, or revenue generated per line per month, was approximately $56.00 for all of 1998. Allegiance received orders for lines from certain Internet service providers during the fourth quarter of 1998. As these lines are installed, the current mix between end-user retail lines and Internet service provider wholesale lines will change. However, the switch capacity used for the Internet service provider lines will be well below Allegiance's policy limit of 20%. Internet service provider wholesale lines typically generate approximately half the revenue yield, excluding the reciprocal compensation component of revenue, of that provided by an end-user retail line. The revenue yield may decline during the first half of 1999 as a result of the change in the mix. However, data and Internet services such as frame relay (a high speed data service used to transmit data between computers), dedicated and dial-up access to the Internet, web page design, e-mail and domain name service, which we introduced in December 1998, may partially, or perhaps completely, offset the reduction anticipated from the receipt of those orders.

Although our primary focus is on serving higher-margin, higher revenue-generating end-user lines, significant Internet wholesale line orders, such as those received during the fourth quarter of 1998, contribute positively to gross margin (even excluding the reciprocal compensation component of revenue). For this reason, we will accept such orders in the future but do not plan to allow the installation of such lines to constitute more than 20% of our switch capacity.

During 1998, Allegiance did not have sales of or revenue from installation of customer premise equipment. Allegiance did not have revenue from system integration activities, wireless, data or Internet services. Allegiance does not plan to sell customer premise equipment or wireless services in the foreseeable future.

Acquisitions during 1999 may increase revenues and revenue yield. Allegiance has had discussions and will continue to have discussions in the foreseeable future, concerning potential acquisitions of Internet service providers and other providers of telecommunications services.

In January 1999, Allegiance announced that it had successfully achieved "electronic bonding" between certain aspects of its operations support systems and those of Bell Atlantic relating to the New York City market. The systems that we currently use to switch customers from their existing carrier to Allegiance and to begin providing them service generally require multiple entries of customer information by hand and are exchanged by fax with the ILEC. Electronic bonding is a method in which manual processing and faxing of information is replaced with electronic processing, where our computer systems and those of other carriers communicate directly. The manual approach that we must use in the absence of electronic bonding not only is labor intensive but also creates numerous opportunities for:

o errors in providing new service and billing;

o service interruptions;

o poor customer service; and

o increased customer turnover.

These problems create added expenses and decrease customer satisfaction.

Without electronic bonding, confirmation of receipt and installation of orders has taken from two business days to one month. Electronic bonding is expected to improve productivity by decreasing the period between the time of sale and the time a customer's line is installed. During 1999, Allegiance expects to electronically bond with Bell Atlantic in other markets and with other ILECs and extend the functionality of the electronic bonding to pre-ordering, billing and certain customer service processes. Currently, Allegiance and Bell Atlantic are testing electronic bonding in Boston. Allegiance and Southwestern Bell are now in the process of testing electronic bonding in the Dallas market. The early results of these efforts have been encouraging. For example, electronic bonding with Southwestern Bell so far has not required a significant change to the software coding written on behalf of Allegiance for the Bell Atlantic electronic bonding. Allegiance and Pacific Bell are discussing the possibility of using this same template to pass service requests between these parties. Ameritech has also contacted us regarding the initiation of a project to electronically bond.

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Network expenses increased from $.2 million in 1997 to $9.5 million in 1998. This sharp increase is consistent with the deployment of our networks and initiation and growth of our services during 1998. Network expenses represent:

o the cost of leasing high-capacity digital lines that interconnect Allegiance's network with ILEC networks;

o the cost of leasing high-capacity digital lines that connect Allegiance's switching equipment to Allegiance transmission equipment located in ILEC central offices;

o the cost of leasing local loop lines, that connect Allegiance's customers to Allegiance's network;

o the cost of leasing space in ILEC central offices for collocating Allegiance transmission equipment; and

o the cost of leasing Allegiance's nationwide Internet network.

The costs to lease local loop lines and high-capacity digital lines from the ILECs vary by ILEC and are regulated by state authorities under the Telecommunications Act of 1996. Allegiance believes that, in many instances, there are multiple carriers in addition to the ILEC from which it can lease high capacity lines and that Allegiance can generally lease those lines at lower prices than are charged by the ILEC. Allegiance expects that the costs associated with these leases will increase with customer volume and will be a significant part of its ongoing cost of services. The cost of leasing switch sites is also a significant part of Allegiance's ongoing cost of services.

On January 25, 1999, the United States Supreme Court reaffirmed the FCC's broad authority to issue rules implementing the Telecommunications Act of 1996, although it did vacate a rule determining which network elements the ILECs must provide to competitors on an unbundled basis. Allegiance, however, leases only the basic unbundled network elements from the ILEC and therefore does not expect reconsideration of the unbundling rules to have an adverse effect on its Smart Build strategy.

Nevertheless, the FCC likely will conduct additional rulemaking proceedings to conform to the Supreme Court's interpretation of the law and these proceedings may result in further judicial review.

In constructing its initial switching and transmission equipment for a new market, Allegiance capitalizes only the non-recurring charges associated with its initial network facilities and the monthly recurring costs of those network facilities until the switching equipment begins to carry revenue-producing traffic. Typically, the charges for just one to two months are capitalized. We expense the monthly recurring and non-recurring costs resulting from the growth of existing collocation sites, and the costs related to expansion of the network to additional collocation sites in operational markets as we incur these charges.

In an effort to reduce network expenses, Allegiance is moving to the next stage of its Smart Build strategy in New York City and Dallas by entering into leases for dark fiber to which Allegiance is installing its own electronic equipment. These leases are accounted for as capital leases. In New York City, Allegiance has entered into an agreement to lease three rings of dark fiber in Manhattan, with an extension into Brooklyn. In the Dallas market, Allegiance has reached an agreement to lease one ring of dark fiber in Dallas County. Allegiance anticipates that any future dark fiber leases will have roughly similar terms and conditions, and therefore it is likely that such additional dark fiber leases, if any, will also be accounted for as capital leases.

We expect "reciprocal compensation" costs to be a major portion of our cost of services. Allegiance must enter into an interconnection agreement with the ILEC in each market to make widespread calling available to Allegiance's customers. These agreements typically set the cost per minute to be charged by each party for the calls that are exchanged between the two carriers' networks. Generally, a carrier must compensate another carrier when a local call by the first carrier's customer terminates on the second carrier's network. These reciprocal compensation costs will grow for Allegiance as its customers' outbound call volume grows. We expect, however, to generate increased revenue from the ILECs as inbound calling volume to our customers increases. If our customers' outbound call volume is equivalent to their inbound call volume, our interconnection costs paid to the ILECs will be substantially offset by the interconnection revenues we receive from them.

The cost of securing long distance service capacity will increase as Allegiance's customers' long distance calling volume increases. Allegiance expects that these costs will be a significant portion of its cost of long distance services. Allegiance has entered into one resale agreement with a long distance carrier to provide Allegiance with the ability to provide our customers with long distance service. Allegiance expects to enter into resale agreements for long distance service with other carriers in the future. Such agreements typically provide for the resale of long distance services on a per-minute basis and may contain minimum volume commitments. Allegiance's existing resale agreement, however, does not contain a minimum volume commitment. If Allegiance agrees to minimum volume commitments and fails to meet them, it may be obligated to pay underutilization charges. Under most of these agreements, if a company underestimates its need for transmission capacity and exceeds the maximum amount agreed to under such agreements, it may be required to obtain capacity through more expensive means.

Allegiance leases high-capacity digital lines which comprise its Internet network, which currently has servers in New York, Dallas and San Francisco. The costs of these lines will increase as Allegiance opens new markets and connects the additional markets to its Internet network.

Selling, general and administrative expenses increased to $46.1 million in 1998 from just $3.4 million in 1997, which is primarily due to the growth of our business. Selling, general and administrative expenses include salaries and related personnel costs, facilities costs and legal and consulting fees. The number of employees increased to 649 as of December 31, 1998, from 40 as of December 31, 1997. As of December 31, 1998, the sales force, including sales managers and sales administrators, had grown to 295. Allegiance did not employ any account executives, major account managers or sales engineers prior to January 1998. During 1999, Allegiance expects the number of its sales personnel to grow significantly. Allegiance currently does not use agents to sell its services, nor does it currently use any print or other media advertising campaigns. As Allegiance continues to grow in terms of number of customers and call volume, we expect that ongoing expenses for customer care and billing will increase.

The magnitude of our net loss for 1998 is principally due to the management ownership allocation charge, a non-cash charge to income. Allegiance's original private equity fund investors and its original management team investors owned 95.0% and 5.0%, respectively, of the ownership interests of Allegiance Telecom, LLC, an entity that owned substantially all of Allegiance's outstanding capital stock prior to Allegiance's initial public offering of its common stock. As a result of this offering, the assets of Allegiance Telecom, LLC, which consisted almost entirely of such capital stock, were distributed to the original fund investors and management investors in accordance with the Allegiance Telecom, LLC limited liability company agreement. This agreement provided that the equity allocation between the fund investors and management investors be 66.7% and 33.3%, respectively, based upon the valuation implied by the initial public offering. Under generally accepted accounting principles, Allegiance recorded the increase in the assets of Allegiance Telecom, LLC allocated to the management investors as a $193.5 million increase in additional paid-in capital. Of this charge, we recorded $122.5 million as a non-cash, non-recurring charge to operating expense and $71.0 million as a deferred management ownership allocation charge. We amortized $44.8 million of the deferred charge in 1998. We will further amortize this deferred charge at $18.8 million, $7.2 million and $.2 million during 1999, 2000, and 2001, respectively. This period is the timeframe over which Allegiance has the right to repurchase the securities, at the lower of fair market value or the price paid by the employee, in the event the management employee's employment with Allegiance is terminated.

In addition to the above expenses, Allegiance recognized $5.3 million and $.2 million amortization of deferred stock compensation expense for the years ended December 31, 1998 and 1997, respectively, also non-cash charges. Such deferred compensation was recorded in connection with membership units of Allegiance Telecom, LLC sold to certain management employees and grants to employees under Allegiance's 1997 Stock Option Plan made prior to Allegiance's initial public offering of common stock.

Depreciation expense increased from approximately $13,000 in 1997 to $9.0 million in 1998, consistent with the completion of Allegiance's networks and initiation of services in nine markets by December 31, 1998.

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Interest expense for the year ended December 31, 1998, was $39.0 million. There was no interest expense incurred during 1997. Interest expense recorded during 1998 reflects: the issuance on February 3, 1998, of 11 3/4% Senior Discount Notes due 2008, and the issuance on July 7, 1998, of 12 7/8% Senior Notes due 2008. See "Liquidity and Capital Resources" on page 41 for a discussion of these note offerings. Allegiance capitalizes a portion of its interest costs as part of the construction cost of its networks, in accordance with Statement of Financial Accounting Standards No. 34. The amount of interest capitalized during 1998 was $2.8 million. No interest was capitalized during 1997. Interest income during 1998 and 1997 was $19.9 million and $.1 million, respectively, resulting from the investment of excess cash and from U.S. government securities that we purchased and placed in a pledge account to secure the semiannual payments of interest through May 2001 on the 12 7/8% Senior Notes due 2008.

Allegiance has recorded the potential redemption value of its redeemable warrants in the event that they are redeemed at fair market value in February 2008. Amounts are accreted using the effective interest method and management's estimates of the future fair market value of such warrants when redemption is first permitted. Amounts accreted increase the recorded value of such warrants on the balance sheet and result in a non-cash charge to increase the net loss applicable to Allegiance's common stock. Accretion of $.5 million related to the redeemable warrants has been recorded for the year ending December 31, 1998.

Until the consummation of Allegiance's initial public offering of common stock, Allegiance also recorded the potential redemption values of its redeemable convertible preferred stock, in the event that they would be redeemed at fair market value in August 2004. At the time of the initial public offering, such preferred stock was converted into common stock. Accordingly, the amounts accreted for the redeemable convertible preferred stock were reclassified as an increase to additional paid-in capital in the stockholders' equity section of the balance sheet, and there has been, and will be, no additional accretion of redeemable convertible preferred stock values beyond that point in time. Accretion related to the redeemable convertible preferred stock of $11.5 million was recorded for the year ending December 31, 1998, and $3.8 million was recorded for the period from inception to December 31, 1997.

Our net loss for 1998, after the non-cash, one-time management allocation charge and amortization of deferred compensation and a portion of the deferred management allocation charge, but before the accretion of the redeemable convertible preferred stock and redeemable warrants, was $246.5 million and was $3.7 million for the period from inception to December 31, 1997. After deducting accretion of preferred stock and warrant values, the net loss applicable to common stock was $258.5 million and $7.5 million for the year ended December 31, 1998, and for the period from inception to December 31, 1997, respectively.

Many securities analysts use the measure of earnings before deducting interest, taxes, depreciation and amortization, also commonly referred to as "EBITDA," as a way of evaluating a company. Allegiance had negative EBITDA of $45.8 million and $3.6 million for the year ended December 31, 1998, and for the period from inception to December 31, 1997, respectively. In calculating EBITDA, Allegiance also excludes the non-cash charges to operations for management ownership allocation charge and deferred stock compensation expense totaling $172.6 million and $.2 million for the year ended December 31, 1998 and for the period from inception to December 31, 1997, respectively.

Allegiance expects to continue to experience increasing operating losses and negative EBITDA as a result of its development activities and as it expands its operations. Allegiance does not expect to achieve positive EBITDA in any market until at least its second year of operation in such market.

Liquidity and Capital Resources

Allegiance's financing plan is predicated on the prefunding of each market's expansion to positive free cash flow. By using this approach, Allegiance avoids being in the position of seeking additional capital to fund a market after Allegiance has already made significant capital investment in that market. We believe that by raising all required capital prior to making any commitments in a market, we can raise capital on more favorable terms and conditions.

Allegiance plans to establish networks in the 24 largest U.S. metropolitan markets. We estimate that we will need approximately $750 million to $850 million to construct these networks and fund our operating losses in these markets to the point of positive free cash flow. We have raised approximately $553.7 million in total capital since our inception. We believe that the proceeds from our current capital raising efforts, together with existing capital resources, will be sufficient to prefund market deployment in all of our 24 targeted markets.

We may decide to seek additional capital in the future to expand our business and sources of additional financing may include vendor financing and/or the private or public sale of Allegiance's equity or debt securities. We cannot ensure, however, that such financing will be available at all or on terms acceptable to Allegiance, or that Allegiance's estimate of additional funds required is accurate.

The actual amount and timing of Allegiance's future capital requirements may differ materially from its estimates as a result of, among other things:

o the cost of the development of its networks in each of its markets;

o a change in or inaccuracy of its development plans or projections that leads to an alteration in the schedule or targets of its rollout plan;

o the extent of price and service competition for telecommunications services in its markets;

o the demand for its services;

o regulatory and technological developments, including additional market developments and new opportunities, in Allegiance's industry; and

o the consummation of acquisitions.

Allegiance's cost of rolling out its networks and operating its business, as well as its revenues, will depend on a variety of factors, including:

o its ability to meet its rollout schedules;

o its ability to negotiate favorable prices for purchases of equipment;

o its ability to develop, acquire and integrate the necessary operations support systems and other back office systems;

o the number of customers and the services for which they subscribe;

o the nature and penetration of new services that Allegiance may offer; and

o the impact of changes in technology and telecommunication regulations.

As such, actual costs and revenues may vary from expected amounts, possibly to a material degree and such variations are likely to affect Allegiance's future capital requirements.

Allegiance initially raised approximately $50.1 million from certain members of the Allegiance management team and from affiliates of four private equity investment funds with extensive experience in financing telecommunications companies: Madison Dearborn Capital Partners, Morgan Stanley Capital Partners, Frontenac Company and Battery Ventures.

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On February 3, 1998, Allegiance raised gross proceeds of approximately $250.5 million in an offering of 445,000 units, each unit consisting of one 11 3/4% note and one redeemable warrant to purchase .0034224719 shares of common stock at an exercise price of $.01 per share, subject to certain antidilution provisions. Net proceeds of approximately $240.7 million were received from this offering. Of the gross proceeds, $242.3 million was allocated to the value of the 11 3/4% notes, and $8.2 million was allocated to the redeemable warrants.

The 11 3/4% notes have a principal amount at maturity of $445.0 million and an effective interest rate of 12.45%. The 11 3/4% notes mature on February 15, 2008. From and after February 15, 2003, interest on such notes will be payable semi-annually in cash at the rate of 11 3/4% per annum. The accretion of original issue discount will cause an increase in indebtedness from December 31, 1998, to February 15, 2008, of $174.5 million.

Allegiance completed the initial public offering of its common stock and the offering of the 12 7/8% notes early in the third quarter of 1998. Allegiance raised net proceeds of approximately $124.8 million from the offering of these notes and approximately $137.8 million from its initial public offering of common stock.

The 12 7/8% notes mature on May 15, 2008. Interest on these notes is payable in cash semi-annually, commencing November 15, 1998. The 12 7/8% notes were sold at less than par, resulting in an effective rate of 13.24%, and the value of the 12 7/8% notes is being accreted, using the effective interest method, from the $200.9 million gross proceeds realized at the time of the sale to the aggregate value at maturity, $205.0 million, over the period ending May 15, 2008. In connection with the sale of the 12 7/8% notes, Allegiance purchased U.S. government securities for approximately $69.0 million and placed them in a pledge account to fund interest payments for the first three years the 12 7/8% notes are outstanding. The first interest payment was made in November 1998. Such U.S. government securities are reflected in the balance sheet as of December 31, 1998, at accreted value of approximately $62.2 million, $25.5 million of which we classified as current assets and $36.7 million of which we classified in other non-current assets.

Allegiance expended $21.9 million and $113.5 million during 1997 and 1998, respectively, for property, plant, equipment, software and hardware necessary in deploying its networks in nine markets and providing operations and other support systems necessary in conducting its business. Allegiance also used capital during 1998 to fund its operations; excess cash was used to purchase short-term investments and money market investments.

On December 31, 1998, Allegiance transmission equipment was collocated in 101 ILEC central offices. Allegiance anticipates that it will more than double the number of collocations during 1999. As of December 31, 1998, Allegiance had committed $17.1 million of its capital for switching equipment and switch facilities and $3.2 million for dark fiber leases. Under Allegiance's current business plans, it plans to make approximately $250 million in capital expenditures in 1999, including approximately $227 million for switching equipment, switch and sales facilities, transmission equipment and collocation facilities.

As of December 31, 1998, Allegiance had approximately $405.9 million of cash and short-term investments. This amount excludes the restricted U.S. government securities that have been placed in a pledge account. Allegiance believes, based on its business plan, that the net proceeds from its current capital raising efforts and previous capital raising activities will be sufficient to prefund its market deployment in all of its 24 targeted markets to the point of positive free cash flow in each of these markets.

On March 19, 1999, Allegiance announced that it intends to offer shares of its common stock in an underwritten primary offering. On that date, Allegiance also announced that it had entered into a letter agreement with Goldman Sachs Credit Partners L.P., TD Securities (USA) Inc. and Morgan Stanley Senior Funding, Inc. to arrange a seven year senior secured revolving credit facility for a subsidiary of Allegiance Telecom, Inc. These banks have received commitments for this facility aggregating in excess of $200.0 million from various lenders. These commitments remain subject to various conditions, including the negotiation and execution of a definitive credit agreement. This revolving facility would be available, subject to satisfaction of certain terms and conditions, to provide purchase money financing for the acquisition, construction and improvement of telecommunications assets by Allegiance's operating subsidiaries. Borrowings under the facility will not be available to us until we reach certain financial and operating objectives, and then will only be available to the extent we have achieved certain further objectives and have maintained certain financial ratios and covenants. Based on Allegiance's current business plan, we do not expect to draw on the facility until year 2000.

The facility will be structurally senior to all of Allegiance's 12 7/8% notes and 11 3/4% notes issued in 1998. The lenders will have a first priority security interest in all of the assets of the Allegiance operating subsidiaries and the stock of the Allegiance borrowing subsidiary. Interest rates under the facility will be tied to the level of debt compared to consolidated EBITDA and is initially expected to be the London Interbank Offering Rate + 3.75%. The commitment fee on the undrawn portion of the facility is initially expected to be 1.50% of the total amount of the facility, with step-downs based on utilization. The facility will also be subject to certain representations, warranties, covenants and events of default customary for credits of this nature and otherwise agreed upon by the parties. We expect that this facility will close in April 1999.

Impact of the Year 2000

The "year 2000" issue generally describes the various problems that may result from the improper processing of dates and date-sensitive transactions by computers and other equipment as a result of computer hardware and software using two digits to identify the year in a date. If a computer program or other piece of equipment fails to properly process dates including and after the year 2000, date-sensitive calculations may be inaccurate. The failure to process dates could result in network and system failures or miscalculations causing disruptions in operations, including, among other things, a temporary inability to process transactions, send invoices or engage in other routine business activities.

The Alliance for Telecommunications Industry Solutions recently tested the U.S. phone system and found no year 2000-related anomalies in the interconnected networks. AT&T and Sprint joined Ameritech, GTE and US West in the Network Testing Committee year 2000 efforts recently completed. The tests focused specifically on the Signaling System 7 and local number portability systems and possible disruptions on December 31, 1999. The Network Testing Committee said it tested call processing, mass calling events and potential network congestion, cross network service call completion and credit card and calling card validation. The Alliance plans to analyze the test in more detail in April 1999.

State of Readiness > Generally, Allegiance has identified two areas for year 2000 review: internal systems and operations, and external systems and services. As a new enterprise, Allegiance does not have older systems that are not year 2000 ready. As it develops its network and support systems, Allegiance intends to ensure that all systems will be year 2000 ready. Allegiance is purchasing its operations support systems with express specifications, warranties and remedies that all systems be year 2000 ready. In addition, Allegiance requires all vendors supplying third-party software and hardware to warrant year 2000 readiness. However, there can be no assurance, until the year 2000, that all systems will then function adequately. Also, Allegiance intends to sell its telecommunications services to companies that may rely upon computerized systems to make payments for such services and to interconnect certain portions of its network and systems with other companies' networks and systems. These transactions and interactions could expose Allegiance to year 2000 problems. Allegiance is in the process of conducting a company-wide inventory of all computer systems on which the company relies, both within and outside of Allegiance. This inventory is scheduled to be completed by the end of May 1999. Allegiance will use this inventory to contact its external suppliers, vendors and providers to obtain information about their year 2000 readiness and, based on that information, will assess the extent to which these external information technology and noninformation technology systems, including embedded technology, could cause a material adverse effect on Allegiance's operations in the event that the systems fail to properly process date-sensitive transactions after December 31, 1999.

Allegiance's assessment of its year 2000 readiness will be ongoing as it continues to develop its own operations support systems and becomes reliant on the systems of additional third parties as a result of the geographic expansion of its business into additional markets. As a result, Allegiance may in the future identify a significant internal or external year 2000 issue that, if not remedied in a timely manner, could have a material adverse effect on Allegiance's business, financial condition and results of operations.

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COSTS TO ADDRESS YEAR 2000 ISSUES > Allegiance has used its internal information technology and other personnel in identifying year 2000 issues. Allegiance does not anticipate any significant costs to make its internal systems year 2000 compliant because it does not expect any remediation to be required and does not expect to make material expenditures for outside consultants to assist Allegiance in its effort to address year 2000 issues. Because no material year 2000 issues have yet been identified in connection with external sources, Allegiance cannot reasonably estimate costs that may be required for remediation or for implementation of contingency plans. As Allegiance gathers information relating to external sources of year 2000 issues, Allegiance will reevaluate its ability to estimate costs associated with year 2000 issues. There can be no assurance that, as additional year 2000 issues are addressed, Allegiance's costs to remediate such issues will be consistent with its historical costs.

RISKS OF YEAR 2000 ISSUES > Allegiance cannot reasonably ascertain the extent of the risks involved in the event that any one system fails to process date-sensitive calculations accurately because it has not identified any material year 2000 issues. Potential risks include:

o the inability to process customer billing accurately or in a timely manner;

o the inability to provide accurate financial reporting to management, auditors, investors and others;

o litigation costs associated with potential suits from customers and investors;

o delays in implementing other information technology projects, as a result of work by internal personnel on year 2000 issues;

o delays in receiving payment or equipment from customers or suppliers, as a result of their systems' failure; and

o the inability to occupy and operate in a facility.

Any one of these risks, if it materializes, could have a material adverse effect on Allegiance's business, financial condition or results of operations.

All of Allegiance's information technology and noninformation technology systems and products relating to Allegiance's external issues are manufactured or supplied by other companies outside of Allegiance's control. As a result, we cannot assure you that the systems of any of those companies will be year 2000 ready. In particular, Allegiance will be dependent upon other ILECs, long distance carriers and other companies for interconnection and completion of off-network calls. These interconnection arrangements are material to Allegiance's ability to conduct its business, and failure by any of these providers to be year 2000 ready may have a material adverse effect on Allegiance's business in the affected market. Moreover, although Allegiance has taken every precaution to purchase its internal systems to be fully year 2000 ready, there can be no assurance that every vendor will fully comply with the contract requirements. If some or all of Allegiance's internal and external systems fail or are not year 2000 ready in a timely manner, there could be a material adverse effect on Allegiance's business, financial condition or results of operations.

CONTINGENCY PLANS > Even though Allegiance has not identified any specific year 2000 issues, Allegiance believes that the design of its networks and support systems could provide Allegiance with certain operating contingencies in the event material external systems fail. In all of its markets, however, Allegiance has or intends to establish interconnection agreements with the ILECs and other regional and international carriers. If one of these carriers fails for any reason, including year 2000 problems, there may be little Allegiance can do to mitigate the impact of such a failure on Allegiance's operations. Allegiance has attempted to ensure that its own operating facilities and systems are fully backed up with auxiliary power generators capable of operating all equipment and systems for indeterminate periods should power supplies fail, subject to the availability of fuel to run these generators. Allegiance also has the ability to relocate headquarters and administrative personnel to other Allegiance facilities should power and other services at its Dallas headquarters fail. Because of the inability of Allegiance's contingency plans to eliminate the negative impact that disruptions in ILEC service or the service of other carriers would create, there can be no assurance that Allegiance will not experience numerous disruptions that could have a material effect on Allegiance's operations.

Report of Independent Public Accountants

To the Board of Directors and Stockholders of Allegiance Telecom, Inc.:

We have audited the accompanying consolidated balance sheets of Allegiance Telecom, Inc. (a Delaware corporation) and subsidiaries (the "Company") as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for the year ended December 31, 1998, and for the period from inception (April 22, 1997), to December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements 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 financial position of Allegiance Telecom, Inc. and subsidiaries as of December 31, 1998 and 1997, and the results of their operations and their cash flows for the year ended December 31, 1998, and for the period from inception (April 22, 1997), to December 31, 1997, in conformity with generally accepted accounting principles.

ARTHUR ANDERSEN LLP

Dallas, Texas, February 3, 1999

Allegiance Telecom, Inc. and Subsidiaries Consolidated Balance Sheets

December 31, 1998 and 1997 (in thousands, except share and per share data)

	1998	1997
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 262,501.7	$ 5,726.4
Short-term investments	143,389.7	--
Short-term investments, restricted	25,542.8	--
Accounts receivable (net of allowance for doubtful accounts of $577.2 and $0, at December 31, 1998 and 1997, respectively)	6,186.6	4.3
Prepaid expenses and other current assets	1,243.2	245.2
Total current assets	438,864.0	5,975.9
PROPERTY AND EQUIPMENT (net of accumulated depreciation and amortization of $9,015.4 and $12.7 at December 31, 1998 and 1997, respectively)	144,860.0	23,899.9

OTHER NONCURRENT ASSETS:		
Deferred debt issuance costs (net of accumulated amortization of $733.7 and $0, at December 31, 1998 and 1997, respectively)	16,078.4	--
Long-term investments, restricted	36,699.2	--
Other assets	1,372.7	171.2
Total other noncurrent assets	54,150.3	171.2
Total assets	$ 637,874.3	$ 30,047.0
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
CURRENT LIABILITIES:		
Accounts payable	$ 20,981.7	$ 2,261.7
Accrued liabilities and other current liabilities	26,176.8	1,668.0
Total current liabilities	47,158.5	3,929.7
LONG-TERM DEBT	471,652.1	--
REDEEMABLE CUMULATIVE CONVERTIBLE PREFERRED STOCK, $.01 par value, 0 and 40,498,062 shares authorized, 0 and 40,498,062 shares issued and outstanding at December 31, 1998 and 1997, respectively	--	33,409.4
REDEEMABLE WARRANTS	8,634.1	--
COMMITMENTS AND CONTINGENCIES (see Notes 6 and 8)		
STOCKHOLDERS' EQUITY (DEFICIT):		
Preferred stock, $.01 par value, 1,000,000 and 0 shares authorized, no shares issued or outstanding at December 31, 1998 and 1997, respectively	--	--
Common stock, $.01 par value, 150,000,000 and 42,629,965 shares authorized, 50,341,554 and 426 shares issued and outstanding at December 31, 1998 and 1997, respectively	503.4	--
Additional paid-in capital	416,729.9	3,008.4
Deferred compensation	(14,617.3)	(2,798.4)
Deferred management ownership allocation charge	(26,224.7)	--
Accumulated deficit	(265,961.7)	(7,502.1)
Total stockholders' equity (deficit)	110,429.6	(7,292.1)
Total liabilities and stockholders' equity (deficit)	$ 637,874.3	$ 30,047.0

The accompanying notes are an integral part of these consolidated financial statements.

Allegiance Telecom, Inc. and Subsidiaries Consolidated Statements of Operations

(in thousands, except share and per share data)

	(A Year Ended December 31, 1998	Period from Inception pril 22, 1997), through December 31, 1997
REVENUE	$ 9,786.2	$ 0.4
OPERATING EXPENSES:		
Network	9,528.8	151.2
Selling, general and administrative	46,089.4	3,425.9
Management ownership allocation charge	167,311.9	--
Noncash deferred compensation	5,307.2	209.9
Depreciation and amortization	9,002.8	12.7
Total operating expenses	237,240.1	3,799.7
Loss from operations	(227,453.9)	(3,799.3)
OTHER (EXPENSE) INCOME:		
Interest income	19,917.4	111.4
Interest expense	(38,951.7)	--
Total other (expense) income	(19,034.3)	111.4
NET LOSS	(246,488.2)	(3,687.9)
ACCRETION OF REDEEMABLE PREFERRED STOCK AND WARRANT VALUES	(11,971.4)	(3,814.2)
NET LOSS APPLICABLE TO COMMON STOCK	$ (258,459.6)	$ (7,502.1)
NET LOSS PER SHARE, basic and diluted	$ (10.53)	$ (17,610.68)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING, basic and diluted	24,550,346	426

The accompanying notes are an integral part of these consolidated financial statements.

Allegiance Telecom, Inc. and Subsidiaries Consolidated Statements of Stockholders' Equity (Deficit)

For the year ended December 31, 1998, and for the period from inception (April 22, 1997), through December 31, 1997 (in thousands, except share and per share data)

	Preferred Stock		Common Stock	
	Number of Shares	Amount	Number of Shares	Amount
Balance, April 22, 1997 (date of inception)	--	$ --	--	$ --
Issuance of common stock at $.23 per share	--	--	426	--
Accretion of redeemable preferred stock and warrant values	--	--	--	--
Deferred compensation	--	--	--	--
Amortization of deferred compensation	--	--	--	--
Net loss	--	--	--	--
Balance, December 31, 1997	--	--	426	--
Accretion of redeemable preferred stock and warrant values	--	--	--	--
Initial public offering	--	--	10,000,000	100.0
Conversion of redeemable preferred stock	--	--	40,341,128	403.4
Deferred compensation	--	--	--	--
Amortization of deferred compensation	--	--	--	--
Net loss	--	--	--	--
Balance, December 31, 1998	--	$ --	50,341,554	$ 503.4

The accompanying notes are an integral part of these consolidated financial statements.

	Additional Paid-In Capital C	Deferred ompensation	Deferred Management Ownership Allocation A Charge	ccumulated Deficit	Total
Balance, April 22, 1997 (date of inception)	$ --	$ --	$ --	$ --	$ --
Issuance of common stock at $.23 per share	0.1	--	--	--	0.1
Accretion of redeemable preferred stock and warrant values	--	--	--	(3,814.2)	(3,814.2)
Deferred compensation	3,008.3	(3,008.3)	--	--	--
Amortization of deferred compensation	--	209.9	--	--	209.9
Net loss	--	--	--	(3,687.9)	(3,687.9)
Balance, December 31, 1997	3,008.4	(2,798.4)	--	(7,502.1)	(7,292.1)
Accretion of redeemable preferred stock and warrant values	--	--	--	(11,971.4)	(11,971.4)
Initial public offering	137,656.8	--	--	--	137,756.8
Conversion of redeemable preferred stock	65,402.0	--	--	--	65,805.4
Deferred compensation	210,662.7	(17,126.1)	(193,536.6)	--	--
Amortization of deferred compensation	--	5,307.2	167,311.9	--	172,619.1
Net loss	--	--	--	(246,488.2)	(246,488.2)
Balance, December 31, 1998	$ 416,729.9	$ (14,617.3)	$(26,224.7)	$(265,961.7)	$ 110,429.6

Allegiance Telecom, Inc. and Subsidiaries Consolidated Statements of Cash Flows

For the year ended December 31, 1998, and for the period from inception (April 22, 1997), through December 31, 1997 (in thousands)

	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (246,488.2)	$ (3,687.9)
Adjustments to reconcile net loss to cash used in operating activities--		
Depreciation and amortization	9,002.8	12.7
Provision for uncollectible accounts receivable	577.2	--
Accretion of senior discount notes	27,762.7	--
Amortization of original issue discount	569.9	--
Amortization of deferred debt issuance costs	733.7	--
Amortization of management ownership allocation charge and deferred compensation	172,619.1	209.9
Changes in assets and liabilities--		
Accounts receivable	(6,759.5)	(4.3)
Prepaid expenses and other current assets	(998.0)	(245.2)
Other assets	(1,201.5)	(171.2)
Accounts payable	4,703.9	275.1
Accrued liabilities and other current liabilities	22,208.1	1,668.0
Net cash used in operating activities	(17,269.8)	(1,942.9)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(113,538.7)	(21,926.0)
Purchases of investments	(294,688.8)	--

Proceeds from redemption of investments	89,057.1	--
Net cash used in investing activities	(319,170.4)	(21,926.0)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from senior notes	443,212.1	--
Proceeds from issuance of redeemable warrants	8,183.5	--
Deferred debt issuance costs	(16,812.1)	--
Proceeds from issuance of redeemable preferred stock	--	5,000.0
Proceeds from redeemable capital contributions	20,875.2	24,595.2
Proceeds from issuance of common stock	--	0.1
Proceeds from initial public offering	137,756.8	--
Net cash provided by financing activities	593,215.5	29,595.3
INCREASE IN CASH AND CASH EQUIVALENTS	256,775.3	5,726.4
CASH AND CASH EQUIVALENTS, beginning of period	5,726.4	--
CASH AND CASH EQUIVALENTS, end of period	$ 262,501.7	$ 5,726.4
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid during the period for interest	$ 9,384.4	$ --

The accompanying notes are an integral part of these consolidated financial statements.

Allegiance Telecom, Inc. and Subsidiaries Notes to Consolidated Financial Statements

December 31, 1998 and 1997 (in thousands, except share and per share data)

1. General:

Allegiance Telecom, Inc., a competitive local exchange carrier (CLEC), was incorporated on April 22, 1997, as a Delaware corporation, for the purpose of providing voice, data, and Internet services to business, government, and other institutional users in major metropolitan areas across the United States. Allegiance Telecom, Inc. and its subsidiaries are referred to herein as the "Company."

The Company's business plan is focused on offering services in 24 of the largest metropolitan areas in the United States. As of December 31, 1998, the Company was operational in nine markets: Atlanta, Boston, Chicago, Dallas, Fort Worth, Los Angeles, New York City, Oakland and San Francisco and is in the process of deploying networks in seven other markets: Houston, Northern New Jersey, Orange County, Philadelphia, San Diego, San Jose and Washington, D.C.

Until December 16, 1997, the Company was in the development stage. From its inception on April 22, 1997, through December 31, 1997, the Company's principal activities included developing its business plans, procuring governmental authorizations, raising capital, hiring management and other key personnel, working on the design and development of its local exchange telephone networks and operations support systems (OSS), acquiring equipment and facilities, and negotiating interconnection agreements. Also, the Company initiated resale services to customers in the Dallas market in December 1997. During 1998, the Company began providing facilities-based services to customers in its markets. During 1998, the Company concentrated on building out the markets it is currently operating in, as well as developing its future markets. Accordingly, the Company has incurred substantial operating losses and operating cash flow deficits.

The Company's success will be affected by the problems, expenses, and delays encountered in connection with the formation of any new business and by the competitive environment in which the Company operates. The Company's performance will further be affected by its ability to assess potential markets, secure financing or raise additional capital, implement expanded interconnection and collocation with incumbent local exchange carrier (ILEC) facilities, lease adequate trunking capacity from ILECs or other CLECs, purchase and install switches in additional markets, implement efficient OSS and other back office systems, develop a sufficient customer base, and attract, retain, and motivate qualified personnel. The Company's networks and the provisions of telecommunications services are subject to significant regulation at the federal, state, and local levels. Delays in receiving required regulatory approvals or the enactment of new adverse regulation or regulatory requirements may have a material adverse effect upon the Company. Although management believes that the Company will be able to successfully mitigate these risks, there is no assurance that the Company will be able to do so or that the Company will ever operate profitably.

Expenses are expected to exceed revenues in each market in which the Company offers service until a sufficient customer base is established. It is anticipated that obtaining a sufficient customer base will take a number of years, and positive cash flows from operations are not expected in the near future.

2. Summary of Significant Accounting Policies:

CONSOLIDATION > The accompanying financial statements include the accounts of Allegiance Telecom, Inc. and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

CASH AND CASH EQUIVALENTS > For purposes of reporting cash flows, the Company includes as cash and cash equivalents, cash, marketable securities, and commercial paper with original maturities of three months or less at date of purchase.

SHORT-TERM INVESTMENTS > Short-term investments consist primarily of commercial paper with original maturities at date of purchase beyond three months and less than 12 months. Such short-term investments are carried at their accreted value, which approximates fair value, due to the short period of time to maturity.

RESTRICTED INVESTMENTS > Restricted investments consist primarily of U.S. government securities purchased in connection with the Company's outstanding 12 7/8% Notes (see Note 4) to secure the first three years' (six semiannual) interest payments on the 12 7/8% Notes. Such investments are stated at their accreted value, which approximates fair value, and are shown in both current and other noncurrent assets, based upon the maturity dates of each of the securities at the balance sheet date.

Restricted investments also includes $787.2 in certificates of deposit held as collateral for letters of credit issued on behalf of the Company. These investments are classified as other noncurrent assets.

ACCOUNTS RECEIVABLE > Accounts receivable consist of end-user receivables, interest receivable, and at December 31, 1997, a receivable from an employee.

PREPAID EXPENSES AND OTHER CURRENT ASSETS > Prepaid expenses and other current assets consist of prepaid rent, prepaid insurance, and refundable deposits. Prepayments are expensed on a straight-line basis over the life of the underlying agreements.

PROPERTY AND EQUIPMENT > Property and equipment includes network equipment, leasehold improvements, software, office equipment, furniture and fixtures, construction-in-progress, and other. These assets are stated at cost, which includes direct costs and capitalized interest, and are depreciated once placed in service using the straight-line method. Interest expense for the year ended December 31, 1998, was $41,749.9 before the capitalization of $2,798.2 of interest related to construction-in-progress. No interest expense was incurred during the period ended December 31, 1997. Repair and maintenance costs are expensed as incurred.

Property and equipment at December 31, 1998 and 1997, consist of the following:

	1998	1997	Useful Lives (in years)
Network equipment	$ 67,303.8	$ --	5-7
Leasehold improvements	24,483.2	37.5	5-10
Software	7,840.0	--	3
Office equipment and other	4,384.3	89.9	2
Furniture and fixtures	2,419.6	150.2	5
Property and equipment, in service	106,430.9	277.6	
Less-accumulated depreciation	(9,015.4)	(12.7)	
Property and equipment, in service, net	97,415.5	264.9	
Construction-in-progress	47,444.5	23,635.0	
Property and equipment, net	$ 144,860.0	$ 23,899.9	

REVENUE RECOGNITION > Revenue is recognized in the month in which the service is provided, except for reciprocal compensation generated by calls placed to Internet service providers connected to the Company's network. The propriety of CLECs (such as the Company) to earn local reciprocal compensation is the subject of numerous regulatory and legal challenges. Until this issue is ultimately resolved, the Company has determined to recognize this revenue only when realization of it is certain, which in most cases will be upon receipt of cash.

COMPREHENSIVE INCOME > In June 1997, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 130 (SFAS 130), "Reporting Comprehensive Income." SFAS 130 established reporting and disclosure requirements for comprehensive income and its components within the financial statements. The Company's comprehensive income components were immaterial as of December 31, 1998, and the Company had no comprehensive income components as of December 31, 1997; therefore, comprehensive income/loss is the same as net income/loss for both periods.

LOSS PER SHARE > The Company calculates net loss per share under the provisions of SFAS No. 128, "Earnings per Share." The net loss per share amounts reflected on the statements of operations and the number of shares outstanding on the balance sheets reflect a 426.2953905-for-one stock split, which occurred in connection with the initial public offering (see Note 3). The net loss applicable to common stock includes the accretion of redeemable cumulative convertible preferred stock and warrant values of $11,971.4 for the year ended December 31, 1998, and $3,814.2 for the period from inception (April 22, 1997), through December 31, 1997.

The securities listed below were not included in the computation of diluted loss per share, since the effect from the conversion would be antidilutive.

	December 31,	
	1998	1997
Redeemable Cumulative Convertible Preferred Stock	--	40,498,062
Redeemable Warrants	649,248	--
1997 Nonqualified Stock Option Plan	886,127	189,127
1998 Stock Incentive Plan	365,526	--
Employee Stock Discount Purchase Plan	44,624	--

RECOGNITION OF THE COST OF START-UP ACTIVITIES > On April 3, 1998, the American Institute of Certified Public Accountants issued Statement of Position No. 98-5 (SOP 98-5), "Reporting on the Costs of Start-up Activities." SOP 98-5 requires that start-up activities and organization costs be expensed as incurred and that start-up costs capitalized prior to the adoption of SOP 98-5 be reported as a cumulative effect of a change in accounting principle. The Company adopted SOP 98-5 during the second quarter of 1998. Adoption of SOP 98-5 did not have an effect on the Company, inasmuch as the Company had previously expensed all such costs.

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES > In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133). SFAS 133 requires that all derivatives be recognized at fair value as either assets or liabilities. SFAS 133 also requires an entity that elects to apply hedge accounting to establish the method to be used in assessing the effectiveness of the hedging derivatives and the measurement approach for determining the ineffectiveness of the hedge at the inception of the hedge. The methods chosen must be consistent with the entity's approach to managing risk. The Company adopted SFAS 133 at the beginning of the fourth quarter of 1998. Adoption of SFAS 133 did not have an effect on the Company, inasmuch as the Company has historically not invested in derivatives or participated in hedging activities.

USE OF ESTIMATES IN FINANCIAL STATEMENTS > 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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. Actual results could differ from those estimates.

RECLASSIFICATIONS > Certain amounts in the prior period's consolidated financial statements have been reclassified to conform with the current period presentation.

3. Capitalization:

In connection with its initial public offering of common stock (the "IPO") on July 7, 1998 (see below), the Company effected a 426.2953905-for-one stock split, which is retroactively reflected within these financial statements.

STOCK PURCHASE AGREEMENT AND SECURITY HOLDERS AGREEMENT > On August 13, 1997, the Company entered into a stock purchase agreement with Allegiance Telecom, LLC ("Allegiance LLC") (see Note 7). Allegiance LLC purchased 40,498,062 shares of 12% redeemable cumulative convertible preferred stock ("Redeemable Preferred Stock"), par value $.01 per share, for aggregate consideration of $5,000.0 (the "Initial Closing"). Allegiance LLC agreed to make additional contributions as necessary to fund expansion into new markets ("Subsequent Closings"). In order to obtain funds through Subsequent Closings, the Company submitted a proposal

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to Allegiance LLC detailing the funds necessary to build out the Company's business in a new market. Allegiance LLC was not required to make any contributions until it approved the proposal. The maximum commitment of Allegiance LLC was $100,000.0. No capital contributions were required to be made after the Company consummated an initial public offering of its stock (which occurred on July 7, 1998).

Allegiance LLC contributed a total of $50,132.9 and $29,595.2 prior to the Company's initial public offering and as of December 31, 1997, respectively. Each security holder in Allegiance LLC had the right to require Allegiance LLC to repurchase all of the outstanding securities held by such security holder at the greater of the original cost (including interest at 12% per annum) for such security or the fair market value, as defined in the security holders agreement, at any time and from time to time after August 13, 2004, but not after the consummation of a public offering or sale of the Company. If repurchase provisions had been exercised, the Company had agreed, at the request and direction of Allegiance LLC, to take any and all actions necessary, including declaring and paying dividends and repurchasing preferred or common stock, to enable Allegiance LLC to satisfy its repurchase obligations.

Because of the redemption provisions, the Company has recognized the accretion of the value of the Redeemable Preferred Stock to reflect management's estimate of the potential future fair market value of the Redeemable Preferred Stock payable in the event the repurchase provisions were exercised. Amounts were accreted using the effective interest method, assuming the Redeemable Preferred Stock is redeemed at a redemption price based on the estimated potential future fair market value of the equity of the Company in August 2004. The accretion was recorded each period as an increase in the balance of Redeemable Preferred Stock outstanding and a noncash increase in the net loss applicable to common stock.

In connection with the IPO, the Redeemable Preferred Stock was converted into common stock, and the amounts accreted were reclassified as a component of additional paid-in capital. In addition, the redemption provisions and the obligation of Allegiance LLC to make additional contributions to the Company (and the obligation of the members of Allegiance LLC to make capital contributions) have terminated.

REDEEMABLE CUMULATIVE CONVERTIBLE PREFERRED STOCK > Each share of the Company's Redeemable Preferred Stock was convertible into shares of the Company's common stock (the "Common Stock") on a one-for-one basis, subject to certain antidilution provisions. No dividends were declared in 1998 or 1997.

In 1998, prior to the conversion of the Redeemable Preferred Stock, the Company recorded accretion of $11,520.8. Accretion recorded in the period ended December 31, 1997, was $3,814.2.

Capital contributed in the Subsequent Closings occurring in October 1997 and January 1998 and other capital contributions totaled approximately $45,132.9.

In February and March 1998, the Company issued 273,361.92 shares of Redeemable Preferred Stock for aggregate consideration of $337.5.

In connection with the consummation of the IPO, the outstanding shares of the Redeemable Preferred Stock were converted into 40,341,128 shares of Common Stock. Upon the conversion of the Redeemable Preferred Stock, the obligation of the Company to redeem the Redeemable Preferred Stock also terminated and, therefore, the accretion of the Redeemable Preferred Stock value recorded to the date of the IPO, $15,335.0, was reclassified to additional paid-in capital along with $50,470.4 proceeds from the issuance of the Redeemable Preferred Stock and redeemable capital contributions.

PREFERRED STOCK > In connection with the IPO, the Company authorized 1,000,000 shares of preferred stock ("Preferred Stock") with a $.01 par value. At December 31, 1998, no shares of Preferred Stock were issued and outstanding.

COMMON STOCK > On July 7, 1998, the Company raised $150,000.0 of gross proceeds in the Company's IPO. The Company sold

10,000,000 shares of its Common Stock at a price of $15 per share. In connection with the IPO, the outstanding shares of Redeemable Preferred Stock were converted into 40,341,128 shares of Common Stock, and the Company increased the number of authorized Common Stock to 150,000,000. At December 31, 1998, 50,341,554 shares were issued and outstanding. Of the authorized but unissued Common Stock, 6,998,970 shares are reserved for issuance upon exercise of options issued under the Company's stock option, stock incentive, and stock purchase plans (see Note 10) and 649,248 shares are reserved for issuance, sale, and delivery upon the exercise of warrants (see Note 4).

DEFERRED COMPENSATION > Allegiance LLC sold to certain management investors (the "Management Investors") membership units of Allegiance LLC at amounts less than their estimated fair market value; therefore, the Company has recognized deferred compensation of $10,090.2 and $977.6 at December 31, 1998 and 1997, respectively, of which $2,726.1 and $40.7 have been amortized to expense at December 31, 1998 and 1997, respectively. In connection with the IPO, the Redeemable Preferred Stock was converted into Common Stock, and Allegiance LLC was dissolved. The deferred compensation charge is amortized based upon the period over which the Company has the right to repurchase certain of the securities (at the lower of fair market value or the price paid by the employee) in the event the management employee's employment with the Company is terminated.

DEFERRED MANAGEMENT OWNERSHIP ALLOCATION CHARGE > On July 7, 1998, in connection with the IPO, certain venture capital investors (the "Fund Investors") and certain Management Investors owned 95.0% and 5.0%, respectively, of the ownership interests of Allegiance LLC, which owned substantially all of the Company's outstanding capital stock. As a result of the successful IPO, Allegiance LLC was dissolved, and its assets (which consisted almost entirely of such capital stock) have been distributed to the Fund Investors and Management Investors in accordance with Allegiance LLC's Limited Liability Company Agreement (the "LLC Agreement"). The LLC Agreement provided that the equity allocation between the Fund Investors and the Management Investors be 66.7% and 33.3%, respectively, based upon the valuation implied by the IPO. Under generally accepted accounting principles, the Company recorded the increase in the assets of Allegiance LLC allocated to the Management Investors as a $193,536.6 increase in additional paid-in capital, of which $122,475.5 was recorded as a noncash, nonrecurring charge to operating expense and $71,061.1 was recorded as a deferred management ownership allocation charge. The deferred charge was amortized at $44,836.4 as of December 31, 1998, and will be further amortized at $18,870.2, $7,175.7, and $178.8 during the years 1999, 2000, and 2001, respectively, which is the period over which the Company has the right to repurchase certain of the securities (at the lower of fair market value or the price paid by the employee) in the event the management employee's employment with the Company is terminated.

4. Long-Term Debt:

Long-term debt consisted of the following:

	December 31,	
	1998	1997
Series B 11 3/4% Notes, face amount $445,000.0 due February 15, 2008, effective interest rate of 12.45%, at accreted value	$ 270,526.1	$ --
12 7/8% Senior Notes, face amount $205,000.0 due May 15, 2008, effective interest rate of 13.24%, at accreted value	201,018.6	--
Other	107.4	--
Total long-term debt	$ 471,652.1	$ --

On February 3,1998, the Company raised gross proceeds of approximately $250,477.1 in an offering of 445,000 Units (the "Unit Offering"), each of which consists of one 11 3/4% Senior Discount Note due 2008 of the Company (the "11 3/4% Notes") and one warrant to purchase .0034224719 shares of Common Stock (the "Redeemable Warrants") at an exercise price of $.01 per share, subject to certain antidilution provisions. Of the gross proceeds, $242,293.6 was allocated to the 11 3/4% Notes and $8,183.5 was allocated to the Redeemable Warrants. The Redeemable Warrants became exercisable in connection with the IPO (see Note 3) in July 1998, and each warrant may now purchase 1.45898399509 shares of Common Stock as a result of the stock split (see Note 3).

A Registration Statement on Form S-4 (File No. 333-49013), registering the Company's 11 3/4% Notes and offering to exchange (the "Exchange Offer") any and all of the outstanding 11 3/4% Notes for Series B 11 3/4% Notes due 2008 (the "Series B Notes"), was declared effective by the Securities and Exchange Commission on May 22, 1998. The Exchange Offer terminated after all of the outstanding 11 3/4% Notes were exchanged. The terms and conditions of the Series B Notes are identical to those of the 11 3/4% Notes in all material respects.

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The Series B Notes have a principal amount at maturity of $445,000.0 and an effective interest rate of 12.45%. The Series B Notes mature on February 15, 2008. From and after February 15, 2003, interest on the Series B Notes will be payable semi-annually in cash at the rate of 11 3/4% per annum.

The Company must make an offer to purchase the Redeemable Warrants for cash at the relevant value upon the occurrence of a repurchase event. A repurchase event is defined to occur when (i) the Company consolidates with or merges into another person if the Common Stock thereafter issuable upon exercise of the Redeemable Warrants is not registered under the Securities Exchange Act of 1934, as amended (the "Exchange Act") or (ii) the Company sells all or substantially all of its assets to another person, if the Common Stock thereafter issuable upon the exercise of the Redeemable Warrants is not registered under the Exchange Act, unless the consideration for such a transaction is cash. The relevant value is defined to be the fair market value of the Common Stock as determined by the trading value of the securities if publicly traded or at an estimated fair market value without giving effect to any discount for lack of liquidity, lack of registered securities, or the fact that the securities represent a minority of the total shares outstanding. As a result of the warrant redemption provisions, the Company is recognizing the potential future redemption value of the Redeemable Warrants by recording accretion of the Redeemable Warrants to their estimated fair market value at February 3, 2008, using the effective interest method. Accretion recorded in the year ended December 31, 1998, was $450.6.

The Series B Notes are redeemable by the Company, in whole or in part, anytime on or after February 15, 2003, at 105.875% of their principal amount at maturity, plus accrued and unpaid interest, declining to 100% of their principal amount at maturity, plus accrued and unpaid interest on and after February 15, 2006. In addition, at any time prior to February 15, 2001, the Company may, at its option, redeem up to 35% of the principal amount at maturity of the Series B Notes in connection with one or more public equity offerings at 111.750% of the accreted value on the redemption date, provided that at least $289,250.0 aggregate principal amount at maturity of the Series B Notes remains outstanding after such redemption.

On July 7, 1998, the Company raised approximately $200,918.5 of gross proceeds from the sale of its 12 7/8% Senior Notes due 2008 (the "12 7/8% Notes"), of which approximately $69,033.4 was used to purchase U.S. government securities, which were placed in a pledge account to secure and fund the first six scheduled payments of interest on the notes (see Note 2).

The 12 7/8% Notes have a principal amount at maturity of $205,000.0 and an effective interest rate of 13.24%. The 12 7/8% Notes mature on May 15, 2008. Interest on the 12 7/8% Notes is payable semi-annually in cash at the rate of 12 7/8% on May 15 and November 15 of each year. As of December 31, 1998, the Company has recorded accrued interest associated with the 12 7/8% Notes of $3,470.2, which is included in other current liabilities.

The 12 7/8% Notes are redeemable by the Company, in whole or in part, at any time on or after May 15, 2003, at 106.438% of their principal amount, declining to 100% of their principal amount, plus accrued interest, on or after May 15, 2006. In addition, prior to May 15, 2001, the Company may redeem up to 35% of the aggregate principal amount of the 12 7/8% Notes with the proceeds of one or more public offerings (as defined in the indenture relating to the 12 7/8% Notes) at 112.875% of their principal amount, plus accrued interest, provided, however, that after any such redemption at least 65% of the aggregate principal amount of the 12 7/8% Notes originally issued remains outstanding.

The Series B and the 12 7/8% Notes carry certain restrictive covenants that, among other things, limit the ability of the Company to incur indebtedness, create liens, engage in sale-leaseback transactions, pay dividends or make distributions in respect to their capital stock, redeem capital stock, make investments or certain other restricted payments, sell assets, issue or sell stock of restricted subsidiaries (as defined in the indentures relating to the Series B Notes and the 12 7/8% Notes), enter into transactions with any holder of 5% or more of any class of capital stock of the Company, or effect a consolidation or merger. In addition, upon a change of control, the Company is required to make an offer to purchase each series of notes at a purchase price of 101% of the accreted value thereof (in the case of the Series B Notes) and 101% of the principal amount thereof (in the case of the 12 7/8% Notes), together with accrued interest, if any. However, these limitations are subject to a number of qualifications and exceptions (as defined in the indentures relating to each series of notes). The Company was in compliance with all such restrictive covenants of each series of notes at December 31, 1998.

<<p57 5. Capital Leases:

On May 29, 1998, the Company signed a capital lease agreement for three, four-fiber rings, with a term of 10 years and a renewal term of 10 years, at an expected total cost of $3,485.0; $871.3 was paid as of December 31, 1998. The remainder is expected to be paid in 1999 and is not reflected in the financial statements, since the payment is contingent upon the timing of completion of network segments.

On December 4, 1998, the Company signed a capital lease agreement for 12 optical fibers configured in two separate rings, with a term of 15 years and two renewal terms of five years each. Total cost associated with the capital lease is dependent upon the timing of completion of connectivity of the optical fibers with the Company's network, which is to be completed in two phases. The Company will incur recurring monthly charges of $29.4 after the completion of phase one. After completion of phase two, the Company will pay a one-time fee of $76.5, and the recurring monthly charge will increase to $76.5. This capital lease is not reflected in the financial statements, since the total cost and timing of payments are contingent upon the timing of completion of the phases.

6. Legal Matters:

On August 29, 1997, WorldCom, Inc. ("WorldCom") sued the Company and two individual employees. In its complaint, WorldCom alleges that these employees violated certain noncompete and nonsolicitation agreements by accepting employment with the Company and by soliciting then-current WorldCom employees to leave WorldCom's employment and join the Company. In addition, WorldCom claims that the Company tortiously interfered with WorldCom's relationships with its employees and that the Company's behavior constituted unfair competition. WorldCom seeks injunctive relief and damages, although it has filed no motion for a temporary restraining order or preliminary injunction. The Company denies all claims and will vigorously defend itself. An estimate of possible loss cannot be made at this time.

On October 7, 1997, the Company filed a counterclaim against WorldCom for, among other things, attempted monopolization of the "one-stop shopping" telecommunications market, abuse of process, and unfair competition. WorldCom moved to dismiss the abuse of process and unfair competition claims. The court dismissed the unfair competition claim on March 4, 1998. Thus, the Company's counterclaim for attempted monopolization and abuse of power are still being litigated.

7. Related Parties:

From inception (April 22, 1997) through July 7, 1998, the Company was a wholly owned subsidiary of Allegiance LLC. On July 7, 1998, the Fund Investors and the Management Investors owned 95.0% and 5.0%, respectively, of the ownership interest of Allegiance LLC, which owned substantially all of the Company's outstanding capital stock. As a result of the successful IPO (see Note 3), Allegiance LLC was dissolved, and its assets (which consisted almost entirely of such capital stock) have been distributed to the Fund Investors and the Management Investors in accordance with the LLC Agreement (see Note 3).

As of July 7, 1998 and 1997, Allegiance LLC had made aggregate capital contributions to the Company of approximately $50,132.9 and $29,595.2, respectively.

During 1998 and 1997, the Company paid all organizational and legal fees of Allegiance LLC, the amount of which was not material. No amounts are due from Allegiance LLC at December 31, 1998, or December 31, 1997.

In connection with the Unit Offering (see Note 4), the IPO (see Note 3), and the sale of the 12 7/8% Notes (see Note 4), the Company incurred approximately $11,331.5 in fees to an affiliate of an investor in the Company.

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8. Commitments and Contingencies:

The Company has entered into various operating lease agreements, with expirations through 2009, for network facilities, office space, and equipment. Future minimum lease obligations related to the Company's operating leases as of December 31, 1998, are as follows:

1999	$ 10,984.8
2000	11,201.6
2001	10,436.7
2002	8,600.8

2003	7,940.7
Thereafter	30,083.5

Total rent expense for the year ended December 31, 1998, was $2,991.8 and for the period from inception (April 22, 1997) through December 31, 1997, was $212.1.

In October 1997, the Company entered into a five-year general agreement with Lucent Technologies, Inc. ("Lucent") establishing terms and conditions for the purchase of Lucent products, services, and licensed materials. This agreement includes a three-year exclusivity commitment for the purchase of products and services related to new switches. The agreement contains no minimum purchase requirements.

9. Federal Income Taxes:

The Company accounts for income tax under the provisions of SFAS No. 109, "Accounting for Income Taxes" (SFAS 109). SFAS 109 requires an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's financial statements. The Company had approximately $53,572.5 and $460.5 of net operating loss carryforwards for federal income tax purposes at December 31, 1998 and 1997, respectively. The net operating loss carryforwards will expire in the years 2012 and 2018 if not previously utilized. The Company has recorded a valuation allowance equal to the net deferred tax assets at December 31, 1998 and 1997, due to the uncertainty of future operating results. The valuation allowance will be reduced at such time as management believes it is more likely than not that the net deferred tax assets will be realized. Any reductions in the valuation allowance will reduce future provisions for income tax expense.

The Company's deferred tax assets and liabilities and the changes in those assets are:

	1997	Change	1998
Start-up costs capitalized for tax purposes	$ 1,025.9	$ (213.7)	$ 812.2
Net operating loss carryforward	156.6	18,058.1	18,214.7
Amortization of original issue discount	--	9,663.6	9,663.6
Depreciation	--	(2,392.4)	(2,392.4)
Valuation allowance	(1,182.5)	(25,115.6)	(26,298.1)
	$ --	$ --	$ --

Amortization of the original issue discount on the Series B Notes and 12 7/8% Notes as interest expense is not deductible in the income tax return until paid.

Under existing income tax law, all operating expenses incurred prior to a company commencing its principal operations are capitalized and amortized over a five-year period for tax purposes.

10. Stock Options/Stock Incentive/Stock Purchase Plans:

At December 31, 1998, the Company had three stock-based compensation plans: the 1997 Nonqualified Stock Option Plan (the "1997 Option Plan"), the 1998 Stock Incentive Plan, and the Employee Stock Discount Purchase Plan (the "Stock Purchase Plan"). The Company applies the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and the related interpretations in accounting for the Company's plans. Had compensation cost for the Company's plans been determined based on the fair value of the options as of the grant dates for awards under the plans, consistent with the method prescribed in SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net loss applicable to Common Stock and net loss per share would have increased to the pro forma amounts indicated below. The Company utilized the following assumptions in calculating the estimated fair value of each option on the date of grant, using the Black-Scholes option-pricing model with the following weighted-average assumptions for grants in 1998 and 1997: dividend yield of 0%, expected volatility of 89.1%, and expected lives of six years for both years: risk-free interest rates of 5.63% in 1998 and 6.06% in 1997 for the 1997 Option Plan and 4.70% in 1998 for the 1998 Stock Incentive Plan.

	1998	1997
Net loss applicable to common stock - as reported	$ 258,459.6	$ 7,502.1
Net loss applicable to common stock - pro forma	259,796.6	7,512.2
Net loss per share, basic and diluted - as reported	10.53	17,610.68
Net loss per share, basic and diluted - pro forma	10.58	17,634.27

As the 1998 Stock Incentive Plan and the Stock Purchase Plan were adopted in 1998, the December 31, 1997, pro forma balances do not include expenses for these plans.

1997 OPTION PLAN AND 1998 STOCK INCENTIVE PLAN > Under the 1997 Option Plan, the Company granted options to key employees, a director, and a consultant of the Company for an aggregate of 1,037,474 shares of the Company's Common Stock. The Company will not grant options for any additional shares under the 1997 Option Plan.

Under the 1998 Stock Incentive Plan, the Company may grant options to certain employees, directors, advisors, and consultants of the Company. The 1998 Stock Incentive Plan provides for issuance of the following types of incentive awards: stock options, stock appreciation rights, restricted stock, performance grants, and other types of awards that the Compensation Committee of the Board of Directors (the "Compensation Committee") deems consistent with the purposes of the 1998 Stock Incentive Plan. The Company has reserved 3,655,778 shares of Common Stock for issuance under the 1998 Stock Incentive Plan.

Options granted under both plans have a term of six years and vest over a three-year period, and the Compensation Committee administers both option plans.

A summary of the status of the 1997 Option Plan as of December 31, 1998 and 1997, is presented in the table below:

	December 31, 1998		December 31, 1997	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of period	189,127	$ 2.47	--	$ --
Granted	848,347	2.76	189,127	2.47
Exercised	--	--	--	--
Forfeited	(151,347)	2.60	--	--
Outstanding, end of period	886,127	2.73	189,127	2.47
Options exercisable at period-end	44,481		--	
Weighted average fair value of options granted	$ 2.82		$ 0.68	

As of December 31, 1998 and 1997, options outstanding under the 1997 Option Plan have a weighted average remaining contractual life of 5.2 and 5.8 years, respectively.

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A summary of the status of the 1998 Stock Incentive Plan as of December 31, 1998, is presented in the table below:

	December 31,1998	
	Weight Shares Exer	ed Average cise Price
Outstanding, beginning of period	--	$ --
Granted	399,974	10.21
Exercised	--	--
Forfeited	(34,448)	10.47
Outstanding, end of period	365,526	10.19
Options exercisable at period-end	--	
Weighted average fair value of options granted	$ 10.22	

As of December 31, 1998, options outstanding under the 1998 Stock Incentive Plan have a weighted average remaining contractual life of 5.7 years.

As the estimated fair market value of the Company's Common Stock (as implied by the IPO price) exceeded the exercise price of the options granted, the Company has recognized deferred compensation of $7,635.0 and $2,030.7 at December 31, 1998 and 1997, respectively, of which $2,581.1 and $169.2 have been amortized to expense at December 31, 1998 and 1997, respectively, over the vesting period of the options. As of December 31, 1998, the Company has reversed $599.1 of unamortized deferred compensation related to options forfeited.

STOCK PURCHASE PLAN > The Company's Stock Purchase Plan is intended to give employees a convenient means of purchasing shares of Common Stock through payroll deductions. Each participating employee's contributions will be used to purchase shares for the employee's share account as promptly as practicable after each calendar quarter. The cost per share will be 85% of the lower of the closing price of the Company's Common Stock on the Nasdaq National Market on the first or the last day of the calendar quarter. The Company has reserved 2,305,718 shares of Common Stock for issuance under the Stock Purchase Plan. As of December 31, 1998, no shares have been issued under the Stock Purchase Plan; however, participants have contributed $303.4 and will be issued 44,624 shares of Common Stock in January 1999. The Compensation Committee administers the Stock Purchase Plan.

EXHIBIT 3.2

CERTIFICATE OF CORRECTION TO AMENDED AND RESTATED CERTIFICATE OF INCORPORATION OF ALLEGIANCE TELECOM, INC.

* * * *

Adopted in accordance with the provisions of '103 (f) of the
General Corporation Law of the State of Delaware

* * * *

Mark B. Tresnowski, being the Secretary of Allegiance Telecom, Inc., a corporation duly organized and existing under and by virtue of the General Corporation Law of the State of Delaware (the "Corporation"), DOES HEREBY CERTIFY as follows:

FIRST: The name of the corporation is Allegiance Telecom, Inc.

SECOND: The Amended and Restated Certificate of Incorporation of the Corporation which was filed with the Secretary of State of Delaware on July 2, 1998 inadvertently deleted provisions from Part C of ARTICLE IV of the Corporation=s Certificate of Incorporation.

THIRD: ARTICLE IV of the Amended and Restated Certificate of Incorporation is hereby corrected to add at the end of Part C thereof, the following:

"(4) Notwithstanding any provision herein to the contrary, in connection with an acquisition of Common Stock as to which the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the AHSR Act") is applicable, until such time as the applicable waiting period (and extensions thereof) under the HSR Act relating to any holder making such acquisition have expired or otherwise terminated, such holder shall have no right to vote the Common Stock (except for votes concerning proposed amendments or waivers to this Certificate of Incorporation).@

IN WITNESS WHEREOF, the undersigned, being the Secretary hereinabove named, for the purpose of correcting the Amended and Restated Certificate of

Incorporation of the Corporation pursuant to the General Corporation Law of the State of Delaware, under penalties of perjury does hereby declare and certify that this is the act and deed of the Corporation and the facts stated herein are true, and accordingly has hereunto signed this Certificate of Correction to Amended and Restated Certificate of Incorporation this 1st day of February, 1999.

Allegiance Telecom, Inc., a Delaware corporation

By: /s/ Mark B. Tresnowski ------------------------------- Mark B. Tresnowski Secretary

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EXHIBIT 10.7

FIRST AMENDMENT
TO THE
ALLEGIANCE TELECOM, INC.
1998 STOCK INCENTIVE PLAN

WHEREAS, the Allegiance Telecom, Inc. 1998 Stock Incentive Plan was adopted by the board of directors and stockholders of Allegiance Telecom, Inc. ("Allegiance").

WHEREAS, Allegiance's board of directors is correcting and amending the Allegiance Telecom, Inc. 1998 Stock Incentive Plan in accordance with Section 16 of such plan.

RESOLVED, that the number of shares of common stock available under the Allegiance Telecom, Inc. 1998 Stock Incentive Plan be corrected by substituting the number "3,655,778" for the number "3,806,658" in Section 4 of this plan. Such correction shall be effective as of December 31, 1998.

FURTHER RESOLVED, that the number of shares of common stock available under the Allegiance Telecom, Inc. 1998 Stock Incentive Plan be increased by substituting the number "6,155,778" for the number "3,655,778" in Section 4 of this plan. Such amendment shall be effective as of March 2, 1999.

FURTHER RESOLVED, that the officers of Allegiance be, and hereby are, authorized to take whatever actions are necessary to carry out the intent and purpose of the foregoing amendment.

EXHIBIT 11.1

ALLEGIANCE TELECOM, INC.

COMPUTATION OF PER SHARE EARNINGS (LOSS)

Year Ended December 31, 1998

(In thousands, except share and per share amounts)

N	umber of Shares Percent	Outstanding	Equivalent Shares
Prior to Initial Public Offering			
1997 Common Stock Offering	426	51.23%	218
After Initial Public Offering			
1997 Common Stock Offering	426	48.77%	208
1998 Common Stock Offering	10,000,000	48.77%	4,876,712
Preferred Stock Converted to Common Stock	40,341,128	48.77%	19,673,208
			24,550,346
WEIGHTED AVERAGE SHARES OUTSTANDING			24,550,346
NET LOSS APPLICABLE TO COMMON STOCK			$ (258,459.6)
NET LOSS PER SHARE, BASIC AND DILUTED			$ (10.53)

EXHIBIT 11.2

ALLEGIANCE TELECOM, INC.

COMPUTATION OF PER SHARE EARNINGS (LOSS)

Period From Inception (April 22, 1997) to December 31, 1997

(In thousands, except share and per share amounts)

N	umber of Shares	Percent Outstanding E	quivalent Shares
1997 Common Stock Offering	426	100.00%	426
WEIGHTED AVERAGE SHARES OUTSTANDING			426
NET LOSS APPLICABLE TO COMMON STOCK		$	(7,502.1)
NET LOSS PER SHARE, BASIC AND DILUTED		$	(17,610.68)

EXHIBIT 13.1

ALLEGIANCE TELECOM, INC.

PORTIONS OF ANNUAL REPORT TO STOCKHOLDERS
FOR THE YEAR ENDED DECEMBER 31, 1998

Selected Financial Data

(dollars in thousands, except share and per share information)

The selected consolidated financial data presented below as of and for the year ended December 31, 1998, and as of and for the period from inception (April 22, 1997) through December 31, 1997, were derived from the audited consolidated financial statements of the Company and should be read in conjunction with "Management's Discussion & Analysis of Financial Condition & Results of Operations" and the Company's audited financial statements and the notes thereto contained elsewhere in this annual report.

	(Ap Year Ended December 31, 1998	Period from Inception ril 22, 1997), through December 31, 1997
Statement of Operations Data:		
Revenue	$ 9,786.2	$ 0.4
Network	9,528.8	151.2
Selling, general and administrative	46,089.4	3,425.9
Management ownership allocation charge	167,311.9	--
Noncash deferred compensation	5,307.2	209.9
Depreciation and amortization	9,002.8	12.7
Loss from operations	(227,453.9)	(3,799.3)
Interest income	19,917.4	111.4
Interest expense	(38,951.7)	--
Net loss	(246,488.2)	(3,687.9)
Accretion of redeemable preferred stock and warrant values	(11,971.4)	(3,814.2)
Net loss applicable to common stock	$ (258,459.6)	$ (7,502.1)
Net loss per share, basic and diluted	$ (10.53)	$ (17,610.68)
Weighted average number of shares outstanding, basic and diluted	24,550,346	426

EXHIBIT 21.1

Subsidiaries of Allegiance Telecom, Inc.

Allegiance Telecom International, Inc., Delaware corporation

Allegiance Telecom Service Corporation, Delaware corporation

Allegiance Internet, Inc., Delaware corporation

Allegiance Telecom of California, Inc., Delaware corporation

Allegiance Telecom of Colorado, Inc., Delaware corporation

Allegiance Telecom of the District of Columbia, Inc., Delaware corporation

Allegiance Telecom of Florida, Inc., Delaware corporation

Allegiance Telecom of Georgia, Inc., Delaware corporation

Allegiance Telecom of Illinois, Inc., Delaware corporation

Allegiance Telecom of Maryland, Inc., Delaware corporation

Allegiance Telecom of Massachusetts, Inc., Delaware corporation

Allegiance Telecom of Michigan, Inc., Delaware corporation

Allegiance Telecom of New Jersey, Inc., Delaware corporation

Allegiance Telecom of New York, Inc., Delaware corporation

Allegiance Telecom of Pennsylvania, Inc., Delaware corporation

Allegiance Telecom of Texas, Inc., Delaware corporation

Allegiance Telecom of Virginia, Inc., Virginia corporation

Allegiance Telecom of Washingtor Inc., Delaware corporation

Allegiance Finance Company, Inc., Delaware corporation

EXHIBIT 23.1

CONSENT OF INDEPENDENT PUBLIC ACCOUNTANTS

As independent public accountants, we hereby consent to the incorporation of our report incorporated by reference in this Form 10-K, into the Company's previously filed Registration Statements on Form S-8 File No. 333-70769 and 333-73453.

ARTHUR ANDERSEN LLP

Dallas, Texas March 29, 1999

ALLEGIANCE TELECOM OF FLORIDA, INC.

EXHIBIT III

EXECUTIVE BIOGRAPHIES

Profiles of Key Management Personnel

Royce J. Holland, the Company's Chairman of the Board and Chief Executive Officer, has more than 25 years of experience in the telecommunications, independent power and engineering/construction industries. Prior to founding Allegiance in April 1997, Mr. Holland was one of several co-founders of MFS, where he served as President and Chief Operating Officer from April 1990 until September 1996 and as Vice Chairman from September 1996 to February 1997. In January 1993, Mr. Holland was appointed by President George Bush to the National Security Telecommunications Advisory Committee. Mr. Holland also presently serves on the Board of Directors of CSG Systems, a publicly held billing services company. Mr. Holland's brother, Stephen N. Holland, is employed as the Company's Senior Vice President and Chief Information Officer.

C. Daniel Yost, who joined the Company as President and Chief Operating Officer in February 1998, was elected to the Company's Board of Directors in March 1998. Mr. Yost has more than 26 years of experience in the telecommunications industry. From July 1997 until he joined the Company, Mr. Yost was the President and Chief Operating Officer for U.S. Operations of Netcom On-Line Communications Services, Inc., a leading Internet service provider. Mr. Yost served as President, Southwest Region of AT&T Wireless Services, Inc. from June 1994 to July 1997. Prior to that, from July 1991 to June 1994, Mr. Yost was the President, Southwest Region of McCaw Cellular Communications/LIN Broadcasting.

Thomas M. Lord, a co-founder and Director of the Company and its Executive Vice President of Corporate Development and Chief Financial Officer, is responsible for overseeing the Company's mergers and acquisitions, corporate finance and investor relations functions. Mr. Lord is an 18-year veteran in investment banking, securities research and portfolio management, including serving as a managing director of Bear, Stearns & Co. Inc. from January 1986 to December 1996. In the five-year period ending December 1996, Mr. Lord oversaw 43 different transactions valued in excess of $6.2 billion for the telecommunications, information services and technology industries.

John J. Callahan, who joined the Company as Senior Vice President of Sales and Marketing in December 1997, has more than 18 years of experience in the telecommunications industry. Most recently, Mr. Callahan was President of the Western Division for MFS from December 1991 to November 1997, where he was responsible for the company's sales and operations in Arizona, California, Georgia, Florida, Illinois, Michigan, Missouri, Ohio, Oregon, Texas and Washington. Prior to joining MFS, Mr. Callahan was Vice President and General Manager, Southwest Division for

Sprint. Mr. Callahan also held sales position with Data Switch and North American Telecom. Mr. Callahan was elected to the Company's Board of Directors in March 1998.

Dana A. Crowne, who joined Allegiance in August 1997, became the Company's Senior Vice President and Chief Technology Office in May 1999. Prior to joining Allegiance, Mr. Crowne held various management positions at MFS from the time of its founding in 1988, where his responsibilities included providing engineering support and overseeing budgets for the construction of MFS' networks. Mr. Crowne ultimately became Vice President, Network Optimization for MFS from January 1996 to May 1997 and managed the company's network expenses and planning and its domestic engineering functions. Prior to joining MFS, Mr. Crowne designed and installed fiber optic transmission systems for Morrison-Knudsen and served as a consultant on the construction of private telecommunications networks with JW Reed and Associates.

Stephen N. Holland joined the Company as its Senior Vice President and Chief Information Officer in September 1997. Prior to that time, Mr. Holland held several senior level positions involving management of or consulting on information systems, accounting, taxation and finance. Mr. Holland's experience includes serving as Practice Manager and Information Technology Consultant for Oracle Corporation from June 1995 to September 1997, as Chief Financial Officer of Petrosurance Casualty Co. from September 1992 to June 1995, as Manager of Business Development for Electronic Data Systems, and as a partner of Price Waterhouse. Mr. Holland's brother, Royce J. Holland, presently serves as the Company's Chairman of the Board and Chief Executive Officer.

Patricia E. Koide has been the Company's Senior Vice President of Human Resources, Real Estate, Facilities and Administration since August 1997. Before then, Ms. Koide was Vice President of Corporate Services, Facilities and Administration for WorldCom from March 1997 to August 1997. Ms. Koide also held various management positions within MFS and its subsidiaries since 1989, including Senior Vice President of Facilities, Administration and Purchasing for MFS North America from 1996 to 1997, Senior Vice President of Human Resources, Facilities and Administration for MFS Telecom from 1994 to 1996, and Vice President of Human Resources and Administration for MFS North America from 1989 to 1993. Prior to MFS, Ms. Koide was with Sprint for eight years where she managed the company's human resources, real estate and facilities for the Midwest.

Gregg A. Long, who became the Company's Senior Vice President of Regulatory and Development in September 1997, spent 11 years at Destec Energy, Inc. as Project Development Manager—Partnership Vice President and Director. In that position, he was responsible for the development of gas-fired power plants from conceptual stages through project financing. Prior to joining Destec, Mr. Long was Manager of Project Finance at Morrison-Knudsen, where he was responsible for analyzing and arranging finance packages for various industrial, mining and civil projects and also served as financial consultant and analyst.

Anthony J. Parella became the Company's National Vice President of Field Sales in September 1998. Mr Parella, who joined the Company as its Regional Vice President, Central Division in August 1997, has more than 10 years of experience in the telecommunications industry. Prior to joining Allegiance, Mr. Parella was Vice President and General Manager for MFS Intelenet, Inc., an operating unit of MFS, from February 1994 to January 1997, where he was responsible for the company's sales and operations in Texas. Mr. Parella also served as Director of Commercial Sales for Sprint from 1991 to January 1994.

L. C. Baird, who became the Company's Regional Vice President, Southeast Division in September 1997, has more than 25 years of experience in the telecommunications industry. Prior to joining Allegiance, Mr. Baird held several senior level positions in operating units of MFS, including serving as President of MFS Intelenet's Southern Division from January 1993 to April 1997 and as vice president of sales and marketing for MFS Network Technologies from August 1987 to January 1993. Mr. Baird also served as area manager for Motorola's Latin American Communications where he was responsible for sales in Central America, Mexico, South America and the Caribbean.

Joseph D'Amico is Regional Vice President, Central Division for Allegiance Telecom, Inc. Most recently, D'Amico was Vice President of the Southwest Region for Allegiance Telecom, responsible for Sales and Operations in the Dallas and Fort Worth offices. Prior to joining Allegiance, D'Amico was Director/Alternate Channels of the Central Region for Winstar Telecommunications. D'Amico also served as Director of Dallas Sales and Operations for MFS Communications Company.

Janette Corby is Regional Vice President, Pacific Division for Allegiance Telecom, Inc. She has more than 15 years of experience in the telecommunications industry. Prior to joining Allegiance, Ms. Corby was Sales Vice President of the AT&T Account Team at SBC Communications where she and her team provided sales and customer care for SBC's largest account with revenues of $800 million annually in California. She also held several senior level positions at Pacific Bell, including Executive Director of Product Management, Director of Sales and Director of Strategic Alliances. Ms. Corby holds an MBA from the University of California, Los Angeles (UCLA).

Sean McDermott is Regional Vice President, Southern California for Allegiance Telecom, Inc. He has more than 15 years of experience in the telecommunications industry. Most recently, he was Vice President/General Manager for MCIWorldcom where he was responsible for sales, operations, real estate, administration and network expansion for all telecommunication services. He also served as National Sales Director for Sprint Corp. McDermott holds a bachelors degree from the University of Colorado, Boulder.

Vince Tozzi is Regional Vice President, Northeast Division for Allegiance Telecom, Inc. He has more than 11 years of experience in the telecommunications industry. Prior to joining Allegiance, he was Vice President of Sales, East at Paetec Communications. After spending five years with Sprint, Mr. Tozzi was the Director of Sales at USTeleCenters, an agent of Nynex, and Vice President of Sales and Operations at WinStar. Mr. Tozzi holds a bachelors degree from Saint Bonaventure University.

Robert McCausland (Vice President Regulatory and Interconnection) worked for affiliates of MFS, now WorldCom, since October 24, 1994. His primary responsibilities included the negotiation, implementation and management of physical and virtual collocation interconnection arrangements with each of the Regional Bell Operating Companies ("RBOCs"), as well as Rochester Telephone, Southern New England Telephone, GTE and the Sprint ILECs. Additionally, he participated in the FCC's collocation proceedings and coordinated the roll out of many of the Company's initial unbundled loop interconnection arrangements. Prior to joining MFS, Mr. McCausland held a number of management positions at Bell Atlantic Corporation.

Dennis Maunder (Vice President - Controller) was Vice President - Controller for US One Communications Corp. from 1995 to the present. He has also spent five years in senior positions at GTE Corporation and 14 years in senior positions at Contel Corporation. He also spent four years at Arthur Anderson & Co.

Tae Kim (Vice President Business Analysis) was most recently Vice President Network Optimization of WorldCom/MFS, where he was responsible for analyzing ways to improve the company's financial performance through optimization of interconnection agreements and third party pricing arrangements.

Ed Bickel (Vice President Engineering) has over twenty years of experience in the coordination and direction of complex electronic maintenance and operations. He was Director, Special Projects at WorldCom, where he oversaw the design and installation of major fiber optic ring systems, and he held a number of director and engineering positions at MFS. Mr. Bickel has held managerial and engineering positions at a number of telecommunications and electronics companies, including Morrison-Knudsen, STS Communications Corporation, National Semiconductor Corporation, and Danray, Inc.

Mark Tresnowski (Senior Vice President, General Council & Secretary) Prior to joining Allegiance, Mark Tresnowski served as a partner in the corporate, securities and venture capital practices at Kirkland & Ellis in Chicago, where he represented Allegiance in the Company's initial public offering of common stock and high-yield debt. Tresnowski represented clients ranging from emerging growth companies to Fortune 100 companies on domestic and international debt and equity financing, mergers and acquisitions and joint ventures. After obtaining a Bachelor of Arts degree from the University of Illinois, Tresnowski graduated from the University of Virginia School of Law where he served as editor of the Virginia Law Review.

Annie Terry (Assistant General Council & Assistant Secretary) Prior to joining Allegiance, Annie Terry was an associate in the corporate, securities and venture capital practices at Kirkland & Ellis in Chicago, where she represented Allegiance in the Company's initial public offering of common stock and high-yield debt. At Kirkland & Ellis, Terry represented clients in public and private mergers, acquisitions and divestitures, public equity offerings, private equity investments, senior credit, mezzanine and other corporate finance transactions. Terry obtained a Bachelor of Science degree in Accountancy from the University of Illinois, and her law degree from the Georgetown University Law Center where she served as a notes editor of the Georgetown Law Review.

ALLEGIANCE TELECOM OF FLORIDA, INC.

EXHIBIT IV

TECHNICAL CAPABILITY

ALLEGIANCE TELECOM OF FLORIDA, INC.

TECHNICAL CAPABILITY

Allegiance Telecom of Florida, Inc., possesses the technical and managerial expertise and experience necessary to provide the services it proposes. As illustrated in Exhibit III the members of Allegiance's senior management team have extensive management and telecommunications experience. Allegiance is guided by a sophisticated and highly able management team that includes individuals who have distinguished themselves in executive positions at some of the top communications firms in America. The senior management team has extensive business, technical, operational and regulatory telecommunications experience, and has been instrumental in the design, implementation and operation of several telecommunications networks. Every level of Applicant's management team comprises individuals who have significant communications experience and who are dedicated to providing the highest quality service to meet customer needs. Allegiance possesses considerable telecommunications expertise and is well qualified to provide both data and voice local exchange services in Florida.

TECHNOLOGIES MANAGEMENT INC

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Winter Park, FL
32789

P.O. Drawer 200
Winter Park, FL
32790-0200

Tel: 407-740-8575
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tmi@tminc.com

DEPOSIT D164 DATE JUL 07 1999

July 6, 1999
Overnight

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*250.00

990883-TX

Mr. Walter D'Haeseleer
Director of Communications
Florida Public Service Commission
2450 Shumard Oak Boulevard
Gerald L. Gunter Building, Room 270
Tallahassee, FL 32399-0850

RE: Initial Alternative Local Exchange Carrier Application of Allegiance Telecom of Florida

Dear Mr. D'Haeseleer:

Enclosed for filing are the original and six copies of the above referenced application of Allegiance Telecom of Florida.

Also enclosed is a check in the amount of $250 for the filing fee. Questions pertaining to this application should be directed to my attention at (407) 740-8575.

Please acknowledge receipt of this filing by returning, file-stamped, the extra copy of this cover letter in the self-addressed, stamped envelope enclosed for this purpose.

Thank you for your assistance.

Sincerely,

DOCUMENT NO. 08119-99 July 7

Carey Roesel
Consultant to Allegiance Telecom of Florida

TECHNOLOGIES MANAGEMENT, INC.
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NATIONSBANK
WINTER PARK, FL 32789

23109

5/21/1999

PAY TO THE ORDER OF Florida Public Service Commission $ **250.00

Two Hundred Fifty and 00/100** DOLLARS

Security features included. Details on back.

Florida Public Service Commission
Records & Reporting
2540 Shumard Oaks Blvd.
Tallahassee, Fl 32302-1500

TECHNOLOGIES MANAGEMENT, INC.

MEMO florida Public Service Commision

⑈023109⑈