TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS—(Continued)

DECEMBER 31, 1997 AND 1996
(In thousands, except share amounts)

	1997	1996
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities ($4,019 in 1997 and $1,079 in 1996 with related parties)	$ 282,231	$ 215,808
Current portion of capital lease obligations ($28,172 in 1997 and $21,139 in 1996 with related parties)	33,724	24,063
Short-term bank debt	52,575	—
Other current liabilities	6,742	2,365
Total current liabilities	375,272	242,236
Capital lease obligations ($13,388 in 1997 and $28,716 in 1996 with related parties)	19,095	34,489
Senior Notes	300,000	300,000
Senior Discount Notes	734,984	659,567
Unamortized notes costs	(23,059)	(25,761)
TCI Subordinated Note (including accrued interest of $0 in 1997 and $1,007 in 1996)	—	27,007
Other liabilities	18,393	15,689
Total liabilities	1,424,685	1,253,227
Commitments and contingencies		
Stockholders' equity:		
Common Stock, Class A $.01 par value: 450,000,000 shares authorized, 61,273,746 and 28,668,400 shares issued and outstanding at December 31, 1997 and 1996	613	287
Common Stock, Class B $.01 par value: 300,000,000 shares authorized, 121,464,778 and 139,250,370 shares issued and outstanding at December 31, 1997 and 1996	1,215	1,393
Additional paid-in capital	1,654,328	1,197,252
Unrealized gain (loss) on marketable securities	164	(25)
Accumulated deficit	(503,679)	(281,012)
	1,152,641	917,895
Less cost of Class B Common Stock held in treasury, 7,975,738 shares at December 31, 1997 and 1996	(121,025)	(121,025)
Total stockholders' equity	1,031,616	796,870
Total liabilities and stockholders' equity	$2,456,301	$2,050,097

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

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

STATEMENTS OF OPERATIONS

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995
(In thousands, except share amounts)

	Consolidated 1997	Consolidated 1996	Combined 1995
Revenues:			
Telecommunications services ($9,968, $2,330 and $154 with related parties in 1997, 1996 and 1995, respectively)	$ 494,304	$ 244,864	$ 134,652
Management and royalty fees from affiliates	—	22,805	31,517
Total revenues	494,304	267,669	166,169
Expenses:			
Operating	283,440	157,591	93,118
Selling, general and administrative	165,977	85,025	50,475
In-process research and development costs	22,000	—	—
Depreciation and amortization	155,402	78,416	37,837
Total expenses	626,819	321,032	181,430
Operating loss	(132,515)	(53,363)	(15,261)
Interest:			
Interest income	31,111	30,219	4,067
Interest expense ($2,022, $14,997 and $18,763 with related parties in 1997, 1996 and 1995, respectively)	(116,172)	(73,633)	(23,331)
Total interest	(85,061)	(43,414)	(19,264)
Loss before minority interest, equity in losses of unconsolidated affiliates and income tax provision	(217,576)	(96,777)	(34,525)
Minority interest	—	3,520	663
Equity in losses of unconsolidated affiliates	(3,427)	(19,400)	(19,541)
Loss before income tax provision	(221,003)	(112,657)	(53,403)
Income tax provision	(1,664)	(2,193)	(401)
Net loss	$ (222,667)	$ (114,850)	$ (53,804)
Loss per share	$ (1.34)	$ (1.00)	$ (0.77)
Weighted average number of shares outstanding	165,728,059	114,443,695	70,000,140

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

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND PARTNERS' CAPITAL (DEFICIT)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995
(In thousands, except share amounts)

	Common Stock	Class B Common Stock	Additional Paid-In Capital	Unrealized Gain (Loss) On Marketable Securities	Accumulated Deficit	Partners' Capital (Deficit)	Treasury Stock	Total Stockholders' Equity and Partners' Capital (Deficit)
Combined balance at January 1, 1995	$ 2	$ —	$ 195,388	$—	$ (33,261)	$17,023	$ —	$179,152
Net loss	—	—	—	—	(32,387)	(21,417)	—	(53,804)
Combined balance at December 31, 1995	2	—	195,388	—	(65,648)	(4,394)	—	125,348
Issuance of 27,025,000 shares of Class A Common Stock, net of issuance costs of $24.8 million	270	—	407,374	—	—	—	—	407,644
Conversion of and 42,000 to 1 stock split of $1.00 par value Common Stock to 139,250,370 shares of Class B Common Stock as part of the TCG Reorganization	(2)	1,393	307,828	—	(100,514)	4,394	—	213,099
Purchase of 7,975,738 shares of Class B Common Stock from Continental Cablevision, Inc.	—	—	—	—	—	—	(121,025)	(121,025)
Conversion of subordinated debt to parents plus accrued interest of $20.6 million to equity	—	—	263,602	—	—	—	—	263,602
Issuance of 1,587,791 shares of Class A Common Stock to purchase the minority interests in two Local Market Partnerships	16	—	22,673	—	—	—	—	22,689
Issuance of 55,609 shares of Class A Common Stock upon exercise of options	1	—	387	—	—	—	—	388
Unrealized loss on marketable securities	—	—	—	(25)	—	—	—	(25)
Net loss	—	—	—	—	(114,850)	—	—	(114,850)
Consolidated balance at December 31, 1996	$287	$1,393	$1,197,252	$(25)	$(281,012)	$ —	$(121,025)	$796,870

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

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND PARTNERS' CAPITAL (DEFICIT)—(Continued)

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995
(In thousands, except share amounts)

	Common Stock	Class B Common Stock	Additional Paid-In Capital	Unrealized Gain (Loss) On Marketable Securities	Accumulated Deficit	Partners' Capital (Deficit)	Treasury Stock	Total Stockholders' Equity and Partners' Capital (Deficit)
Issuance of 7,304,408 shares of Class A Common Stock, net of issuance costs of $11.3 million....	73	—	317,324	—	—	—	—	317,397
Issuance of 990,639 shares of Class A Common Stock upon exercise of options and employee stock grants	9	—	16,484	—	—	—	—	16,493
Issuance of 2,100,000 shares of Class A Common Stock to purchase CERFnet Services, Inc ...	21	—	47,386	—	—	—	—	47,407
Issuance of 2,757,083 shares of Class A Common Stock to purchase remaining interest in Eastern TeleLogic Corporation	28	—	46,050	—	—	—	—	46,078
Issuance of 1,667,624 shares of Class A Common Stock to purchase the remaining interest in BizTel Communications, Inc.	17	—	29,832	—	—	—	—	29,849
Conversion of 17,785,592 shares of Class B Common Stock to Class A Common Stock	178	(178)	—	—	—	—	—	—
Unrealized gain on marketable securities	—	—	—	189	—	—	—	189
Net loss	—	—	—	—	(222,667)	—	—	(222,667)
Consolidated balance at December 31, 1997	$613	$1,215	$1,654,328	$164	$(503,679)	$—	$(121,025)	$1,031,616

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

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

STATEMENTS OF CASH FLOWS

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

(In thousands)

	Consolidated 1997	Consolidated 1996	Combined 1995
Cash flows from operating activities:			
Net loss	$(222,667)	$ (114,850)	$ (53,804)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities, net of effects of the TCG Reorganization and acquisitions:			
Depreciation and amortization	155,402	78,416	37,837
Amortization of notes costs	2,702	1,350	—
Equity in losses of unconsolidated affiliates	3,427	19,400	19,541
In-process research and development costs	22,000	—	—
Amortization of deferred credits	(18,178)	(2,965)	(2,228)
Provision for losses on accounts receivable	11,526	3,442	877
Accretion of discount on Senior Discount Notes	75,417	34,567	—
Minority interest	—	(3,520)	(663)
Other	(1,914)	—	—
(Increase) decrease in operating assets and (decrease) increase in operating liabilities:			
Accounts receivable	(48,608)	(18,386)	(12,771)
Other assets	(21,786)	(3,596)	(3,108)
Accounts payable and accrued liabilities	(3,709)	97,230	45,832
Deferred credits	25,177	2,530	4,628
Net cash (used in) provided by operating activities	(21,211)	93,618	36,141
Cash flows from investing activities:			
Capital expenditures	(462,791)	(294,078)	(139,656)
Due from related parties	—	(23,042)	(6,707)
Purchases of marketable securities, net of sales and maturities	134,166	(440,831)	—
Purchase of a Local Market Partnership interest	—	(11,618)	—
Capital contributions to Local Market Partnerships prior to TCG Reorganization	—	(16,435)	—
Investments in and advances to unconsolidated affiliates	(6,290)	(127,509)	(65,004)
Repayment of advances to unconsolidated affiliate	—	—	3,400
Cash paid for acquisitions, net of cash acquired	(6,709)	—	—
Net cash used for investing activities	(341,624)	(913,513)	(207,967)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	—	162,500	159,000
Payments on bank revolving credit facility	—	(250,000)	—
Proceeds from Senior Notes	—	300,000	—
Proceeds from Senior Discount Notes	—	625,000	—
Costs associated with the Offerings	(11,302)	(51,867)	—
Proceeds from the issuance of Class A Common Stock	328,699	432,400	—
Proceeds from the exercise of employee stock options	11,721	388	—
Purchase of treasury stock	—	(121,025)	—
Capital contributions from minority partners	—	—	2,168
Principal payments on capital leases	(45,399)	(11,823)	(3,480)
Repayment of TCI Subordinated Note, net of discount	(25,093)	—	—
Net cash provided by financing activities	258,626	1,085,573	157,688
Net (decrease) increase in cash and cash equivalents	(104,209)	265,678	(14,138)
Cash and cash equivalents, January 1	277,540	11,862	26,000
Cash and cash equivalents, December 31	$ 173,331	$ 277,540	$ 11,862

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

TELEPORT COMMUNICATIONS GROUP INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995

1. Organization and Operations

Teleport Communications Group Inc. ("TCG" or the "Company"), the first and largest competitive local exchange carrier ("CLEC") in the United States, offers comprehensive telecommunications services in major metropolitan markets nationwide. TCG competes with incumbent local exchange carriers ("ILECs") by providing high quality, integrated telecommunications services, primarily over fiber optic digital networks, to meet the voice, data and video transmission needs of its customers. TCG's customers are principally telecommunications intensive-businesses, healthcare and educational institutions, governmental agencies, long distance carriers and resellers, Internet service providers, disaster recovery service providers, wireless communications companies and financial services companies. TCG offers these customers technologically advanced telecommunications services, as well as superior customer service, flexible pricing and vendor and route diversity.

TCG, incorporated in March 1983, and TCG Partners, formed in December 1992, were each owned by Cox Communications, Inc. ("Cox"), Tele-Communications, Inc. ("TCI"), Comcast Corporation ("Comcast"), and Continental Cablevision, Inc. ("Continental") (collectively the "Cable Stockholders") until June 26, 1996.

In connection with the public offerings of Class A Common Stock, Senior Notes and Senior Discount Notes on July 2, 1996, TCG and its owners entered into a reorganization agreement dated as of April 18, 1996 (the "TCG Reorganization Agreement"), pursuant to which TCG Partners and certain of the Company's unconsolidated affiliates became wholly-owned subsidiaries of TCG and TCG acquired the minority interests of the owners of the remaining unconsolidated affiliates.

TCG Reorganization and the 1997 and 1996 Offerings

1997 Equity Offering

TCG filed a registration statement for a public offering (the "1997 Offering") of 17,250,000 shares of Class A Common Stock on October 10, 1997, and the 1997 Equity Offering was consummated on November 13, 1997. Of the 17,250,000 shares, 7,304,408 were offered by the Company and 9,945,592 shares were offered by Continental. The Company did not receive any proceeds from the sale of shares by Continental. The net proceeds to the Company from its sale of shares pursuant to the 1997 Equity Offering were approximately $317.4 million, after deducting the underwriting discount and estimated expenses of approximately $11.3 million.

1996 Offerings

On July 2, 1996, the Company issued 27,025,000 shares of Class A Common Stock which resulted in gross proceeds of approximately $432.4 million (the "Stock Offering"), and $300 million of 9⅞% Senior Notes due 2006 and $1,073 million of aggregated principal amount of maturity of 11⅛% Senior Discount Notes due 2007 ("the Notes Offerings" and, collectively, with the Stock Offering, the "1996 Offerings") as part of an initial public offering. The Offerings of the Senior Notes and the Senior Discount Notes resulted in aggregate gross proceeds of approximately $925 million. In July 1996, the Company utilized a portion of the net proceeds of the 1996 Offerings to (i) repay $250 million of bank indebtedness plus accrued interest and (ii) purchase 7,975,738 shares of Class B Common Stock owned by Continental for $16.00 per share, less related expenses, for a net cost of $121 million. In addition, a portion of the proceeds was used to loan approximately $115 million to its affiliate Comcast CAP of Philadelphia, Inc. ("Comcast CAP"), as part of the first step in TCG's acquisition of Eastern TeleLogic Corporation. The remaining funds were and will be used to expand and develop existing and new networks, to repay the TCI Subordinated Note, to make acquisitions and for general corporate and working capital purposes.

TCG Reorganization

Prior to the 1996 Offerings, the Company was owned by the Cable Stockholders. The business was operated through TCG, and beginning in 1992, TCG Partners, which is a New York general partnership owned prior to the TCG Reorganization by the Cable Stockholders in the same percentages as TCG. TCG Partners was formed to invest, with TCG, the Cable Stockholders and other cable operators, in 14 partnerships (the "Local Market Partnerships") to develop and operate local telecommunications networks. The Local Market Partnerships were owned by TCG, and/or TCG Partners, certain of the Cable Stockholders which had cable operations in the particular markets addressed by the Local Market Partnerships, and, in some cases, other cable operators in such markets. To simplify this complex ownership structure, the Company and the Cable Stockholders agreed to consolidate the ownership of TCG Partners and of the Local Market Partnerships as wholly-owned subsidiaries of TCG. As part of this process, certain of the other cable operators agreed to sell their interests in the Local Market Partnerships to TCG directly or through a Cable Stockholder. The financial statements for one of the Local Market Partnerships were previously consolidated with those of TCG. Therefore, TCG consolidated the financial statements of the remaining 13 of the 14 Local Market Partnerships.

Unaudited pro forma financial information for the year ended December 31, 1996, as if the TCG Reorganization had occurred at the beginning of 1996 is as follows (in thousands, except share amounts):

Revenues	$ 283,383
Expenses:	
Operating	172,374
Selling, general and administrative	98,436
Depreciation and amortization	96,260
Total expenses	367,070
Operating loss	(83,687)
Interest:	
Interest income	29,163
Interest expense	(66,946)
Total interest	(37,783)
Loss before minority interest, equity in losses of unconsolidated affiliates and income tax provision	(121,470)
Minority interest	4,713
Equity in losses of unconsolidated affiliates	(7,650)
Loss before provision for income taxes	(124,407)
Income tax provision	(2,193)
Net loss	$ (126,600)
Loss per share	$ (0.86)
Weighted average number of shares outstanding	146,423,705

Pro forma adjustments include the reversal of TCG's equity in the losses of 13 Local Market Partnerships, as well as amortization of the goodwill which was recorded upon closing of the transactions and the reduction of interest expense from the conversion to equity of subordinated debt owed by TCG to the Cable Stockholders. The pro forma financial information presented above is not necessarily indicative of the operating results which

would have been achieved had the transactions occurred at the beginning of the periods presented or of the results to be achieved in the future.

As of December 31, 1997, TCI, Cox and Comcast owned 42.98%, 34.44% and 22.58%, respectively, of the Company's Class B Common Stock, representing 40.86%, 32.68% and 21.42%, respectively, of the combined voting power of the Company's Common Stock. As of December 31, 1997, TCG was owned 28.49%, 22.37%, 14.66% and 34.48% by TCI, Cox, Comcast and public shareholders, respectively.

The AT&T Merger

On January 8, 1998, TCG entered into an Agreement and Plan of Merger (the "AT&T Agreement") with AT&T Corp., a New York Corporation ("AT&T"), and TA Merger Corp., a Delaware corporation and a wholly-owned subsidiary of AT&T ("AT&T Merger Sub"), pursuant to which, subject to satisfaction of the closing conditions specified therein, AT&T Merger Sub would merge with and into TCG, with TCG surviving as a wholly-owned subsidiary of AT&T (the "AT&T Merger").

In the AT&T Merger, each share of TCG Class A Common Stock (including shares issued to former ACC stockholders in the ACC Merger, assuming that the ACC Merger occurs prior to the AT&T Merger) and each share of the Class B Common Stock of TCG, par value $0.01 per share (the "TCG Class B Common Stock," and, together with the TCG Class A Common Stock, the "TCG Common Stock") will be converted into 0.943 of a share of AT&T common stock. TCG and AT&T expect that the exchange will be tax-free to TCG stockholders, except to the extent cash is received in lieu of fractional shares. The AT&T Agreement contains customary representations and warranties of the parties, which will not survive effectiveness of the AT&T Merger. In addition, the AT&T Agreement contains certain restrictions on the conduct of TCG's business prior to the consummation of the AT&T Merger. Pursuant to the AT&T Agreement, TCG has agreed, for the period prior to the AT&T Merger, to operate its business in the ordinary course, refrain from taking various corporate actions without the consent of AT&T, and not solicit or enter into negotiations or agreements relating to a competing business combination.

Pursuant to a Voting Agreement among the Cable Stockholders and AT&T, each Cable Stockholder executed and delivered to TCG a written consent in favor of and approving the AT&T Agreement and the AT&T Merger. As a result, so long as the provisions of the AT&T Agreement are not amended or waived, as specified therein, no further vote or meeting of TCG Stockholders is necessary to approve or consummate the AT&T Merger.

Pursuant to the Voting Agreement, each of the Cable Stockholders, on behalf of itself and certain of its affiliates, also agreed that (i) certain rights-of-way, colocation and similar agreements with TCG and its affiliates would be amended as of January 8, 1998 to provide that each such agreement would remain in effect for the longer of five years from such date and the current term of such agreement; and (ii) certain existing facilities agreements, facilities lease agreements or other arrangements (including arrangements relating to future agreements) relating to the lease or other grant of right to use fiber optic facilities between such Cable Stockholder or any of its affiliates and TCG or any of its subsidiaries would be automatically amended as of January 8, 1998 to conform with a form of Master Facilities Agreement agreed to by AT&T, the Cable Stockholders and TCG at the time of the execution of the AT&T Agreement.

Consummation of the AT&T Merger is subject to certain closing conditions, including TCG and AT&T obtaining certain required regulatory approvals and other related consents. Accordingly, there can be no assurance that the AT&T Merger will be successfully consummated or, if successfully completed, when it might be completed.

2. Significant Accounting Policies

Basis of Presentation—The 1997 consolidated balance sheet and statements of operations and of cash flows include the accounts of TCG and all wholly-owned subsidiaries. The 1996 consolidated balance sheet includes the accounts of TCG and all wholly-owned subsidiaries. The 1996 consolidated statements of operations and of cash flows include equity in losses of unconsolidated affiliates for all the Local Market Partnerships through June 30, 1996 except for TCG St. Louis which was consolidated for the year. As of July 1, 1996, the statements of operations and of cash flows consolidate the operations of the former Local Market Partnerships. For the year ended December 31, 1995, the statements of operations and of cash flows include the combined accounts of TCG and TCG Partners. Investments in which TCG holds less than a 50% interest are accounted for under the equity method. All material intercompany transactions and balances have been eliminated in the financial statements presented.

Basis of Accounting—The accompanying financial statements have been prepared on the accrual basis of accounting.

Use of Estimates—The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash Equivalents—Cash equivalents consist principally of fixed income securities, U.S. Treasury bills, commercial paper, floating rate notes and certificates of deposit with a maturity date of three months or less when purchased.

Marketable Securities—Marketable securities consist principally of fixed income securities, U.S. Treasury bills, commercial paper, floating rate notes, federal agency notes, federal agency discount notes, corporate medium-term notes, corporate notes, bank notes and certificates of deposit with a maturity date greater than three months when purchased and are stated at market value. Market value is determined by the most recently traded price of the security at the balance sheet date. TCG invests primarily in high-grade marketable securities. All marketable securities are classified as available for sale securities under the provisions of SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities" and unrealized holding gains and losses are reflected as part of stockholders' equity. Net realized gains and losses are determined on the specific identification cost method.

Depreciation and Amortization—Depreciation and amortization are computed on the straight-line basis over the estimated useful lives of the assets or the length of the lease, whichever is shorter. Estimated useful lives are five to 25 years for the communications network and three to five years for other fixed assets, except for buildings which are 40 years.

When depreciable assets are replaced or retired, the amounts at which such assets were carried are removed from the respective accounts and charged to accumulated depreciation and any gains or losses on disposition are amortized over the remaining original asset lives in accordance with industry practice.

During 1995, TCG completed a review of the useful lives of its fixed assets. TCG determined that the lives of certain electronics equipment were longer than industry standard, while the lives of other electronics equipment were shorter than industry standard. Therefore, TCG adjusted the estimated useful lives of certain

electronics equipment to conform with industry standard, effective December 1, 1995. The effect of these changes increased depreciation expense for the year ended December 31, 1995 by approximately $0.7 million.

Financial Instruments—Financial instruments which potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents, marketable securities and accounts receivable. The Company places its temporary cash and cash equivalents and marketable securities with high-quality institutions and, by policy, limits the amount of credit exposure to any one institution. Concentrations of credit risk with respect to accounts receivable are limited due to the dispersion of TCG's customer base among different industries and geographic areas in the United States, by credit granting policies adopted by TCG and by remedies provided by terms of contracts, tariffs and statutes.

Fair Value of Financial Instruments—The estimated fair value amounts have been determined by the Company, using available market information and appropriate valuation methodologies. However, considerable judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

Investments In and Advances to Unconsolidated Affiliates—Investments in and advances to unconsolidated affiliates at December 31, 1997 represents TCG's interest in three companies which TCG accounts for under the cost method of accounting. At December 31, 1996 it is comprised of TCG's advance to ETC and its 49.9% interest in BizTel.

Goodwill and Other Intangibles—Goodwill represents the excess purchase price paid over the net assets received in the acquisitions of ETC, CERFnet, and the excess purchase price paid over the net assets associated with the purchase of the remaining partnership interests in Teleport Communications, Teleport Communications Boston ("TCB"), TCG Florida, TCG Detroit and TCG San Francisco, as well as goodwill recorded in the financial statements of TCG Pittsburgh, which is included in the consolidated financial statements of TCG after the TCG Reorganization. Goodwill is amortized on a straight-line basis not to exceed 40 years for all entities. The goodwill amortization recorded in 1997, 1996 and 1995 was $7.9 million, $2.2 million and $1.4 million, respectively.

The carrying value of intangible assets is periodically reviewed and impairments are recognized when the undiscounted expected future cash flows, computed after interest expense derived from the related operations, is less than their carrying value.

Licenses—FCC Licenses, acquired in the BizTel acquisition, are amortized over a 40 year period in accordance with industry practice. The amortization recorded in 1997 was $0.2 million.

Deferred Charges—Deferred charges primarily represent advanced payments made by TCG for rights-of-way and node rents, and are expensed over a maximum period of five years. The current portions of $4.6 million and $1.6 million at December 31, 1997 and 1996, respectively, are included in other current assets and the non-current portions, $8.9 million and $8.9 million at December 31, 1997 and 1996, respectively, are included in other assets.

Deferred Credits—Deferred credits principally represent advance payments received from customers for long-term fiber optic service, and are amortized into income over the life of the related contracts. The current portions, $6.7 million and $2.4 million at December 31, 1997 and 1996, respectively, are included in other current liabilities and the non-current portions, $15.0 million and $9.9 million at December 31, 1997 and 1996, respectively, are included in other liabilities.

Revenue Recognition—Revenue on dedicated line, switch, data, and Internet services is recognized in accordance with the terms of the underlying customer contracts or tariffs and over the period in which the services are provided.

Income Taxes—TCG accounts for income taxes in accordance with the Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes," pursuant to which deferred income tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates currently in effect. State and local taxes are based on factors other than income.

Net Loss Per Share—In 1997, TCG has adopted SFAS No. 128, "Earnings per Share", which had no effect on its computation of loss per share. Net loss per share is determined by dividing net loss by the weighted average number of common shares outstanding for the period. The computation of fully diluted net loss per share was antidilutive in each of the periods presented; therefore, the amounts reported as primary and fully diluted are the same. As part of the TCG Reorganization, TCG declared a 42,000 to one stock split. All per share amounts and numbers of shares have been restated to reflect the stock split retroactive for the periods presented.

Recently Issued Accounting Pronouncements

Comprehensive Income—In June 1997, the Financial Accounting Standards Board ("FASB") issued SFAS No. 130, "Reporting Comprehensive Income." This statement is effective for financial statements issued for periods beginning after December 15, 1997. Management has evaluated the effect on its financial reporting of the adoption of this statement and has found the majority of required disclosures not to be applicable and the remainder not to be significant.

Segments of an Enterprise and Related Information—In June 1997, the FASB issued SFAS No. 131, "Disclosure about Segments of an Enterprise and Related Information." This statement is effective for fiscal years beginning after December 15, 1997. SFAS No. 131 requires the reporting of profit and loss, specific revenue and expense items, and assets for reportable segments. It also requires the reconciliation of total segment revenues, total segment profit or loss, total segment assets, and other amounts disclosed for segments, in each case to the corresponding amounts in the general purpose financial statements. The Company has not yet determined what additional disclosures may be required in connection with adopting SFAS No. 131.

3. Acquisitions

BizTel Communications, Inc.

On October 29, 1997, the Company acquired the remaining 50.1% equity interest in BizTel Communications, Inc. ("BizTel") not owned by the Company in exchange for the issuance of 1,667,624 shares of the Company's Class A Common Stock. The Company had previously acquired a 49.9% interest in BizTel, in February 1996. The total acquisition cost was $40.0 million. BizTel is a holder of Federal Communications Commission ("FCC") licenses to provide telecommunications services utilizing 38 GHz digital milliwave transmission in over 200 geographic areas, which include more than 95 of the 100 largest metropolitan markets and all markets where TCG operates. BizTel's 38 GHz milliwave services can be used to economically connect customers to the Company's fiber optic networks, to provide network redundancy, diverse routing or quick temporary installations and to provide stand-alone facilities where the Company does not have fiber optic networks. As of November 1, 1997, TCG consolidates BizTel's results with its wholly-owned subsidiaries.

TCG evaluated the acquired assets and liabilities of BizTel, and as a result of the evaluation, TCG ascribed a value to the FCC Licenses of $39.7 million. Such amount is being amortized over 40 years and is reported in the statement of operations in depreciation and amortization expense. Amortization expense related to such FCC Licenses for the year ended December 31, 1997 was $0.2 million.

Eastern TeleLogic Corporation

Effective as of March 1, 1997, TCG completed its acquisition of Eastern TeleLogic Corporation ("ETC"). In the first of two steps, on October 25, 1996, employees of ETC exercised their stock options and then ETC redeemed the shares of its stock (approximately 47%) not held by Comcast CAP, a corporation owned 51% by Comcast and 49% by TCG. Comcast CAP borrowed at a market interest rate approximately $115 million from TCG as a short-term loan and, in turn, loaned this amount to ETC to effect the redemption. In the second step, TCG acquired Comcast's 51% stock interest in Comcast CAP in exchange for 2,757,083 shares of the Company's Class A Common Stock, resulting in ETC becoming a wholly-owned subsidiary of TCG. After the acquisition, the name of ETC was changed to TCG Delaware Valley, Inc. TCG assumed $52.6 million of debt in this acquisition. TCG retained an independent third party to fully evaluate certain acquired assets of ETC.

The total acquisition cost for ETC was $178.7 million. The goodwill recorded with this investment, which represented the excess of the Company's investment over the underlying net assets of ETC, was approximately $167.8 million. Such amount is being amortized over 40 years and is reported in the statement of operations in depreciation and amortization expense. Amortization expense related to such goodwill for the year ended December 31, 1997 was $4.2 million.

CERFnet Services, Inc.

On February 4, 1997, the Company acquired from General Atomics and General Atomic Technologies Corporation all of the outstanding capital stock of CERFnet Services, Inc. ("CERFnet"), a leading regional provider of Internet-related services to businesses, including dial-up and dedicated Internet access, World Wide Web hosting, and colocation services and Internet training. TCG issued 2,100,000 shares of its Class A Common Stock to CERFnet's former controlling stockholder and granted to it certain registration rights with respect to such shares of Class A Common Stock. After the acquisition, the name of CERFnet was changed to TCG CERFnet, Inc.

TCG retained an independent third party to evaluate certain of the acquired assets of CERFnet, and as a result of the evaluation, TCG expensed acquired in-process research and development costs of $22.0 million.

The goodwill recorded with this investment, which represented the excess of the Company's investment over the underlying net assets of CERFnet was approximately $19.9 million. Such amount is being amortized over 10 years and is reported in the statement of operations in depreciation and amortization expense. Amortization expense related to such goodwill for the year ended December 31, 1997 was approximately $1.8 million.

Summarized Financial Information

Summarized financial information for the Company's investments, which include BizTel and ETC and six months of the revenues and net losses of the Local Market Partnerships except for TCG St. Louis as of and for the year ended December 31, 1996, is as follows (in thousands):

Total assets	$ 68,053
Total liabilities	185,820
Total revenues	63,940
Net loss	(52,311)

ACC Merger

On November 26, 1997, TCG entered into an Agreement and Plan of Merger (the "ACC Agreement") by and among TCG, TCG Merger Co., Inc., a Delaware corporation and a wholly-owned subsidiary of TCG

("MergerCo"), and ACC Corp., a Delaware corporation ("ACC"), providing for the merger of MergerCo with and into ACC (the "ACC Merger"), with ACC becoming a wholly-owned subsidiary of TCG. ACC is a switch-based provider of telecommunications services to businesses, residential customers, and educational institutions in the United States, United Kingdom and Canada. ACC has recently commenced operations in Germany. The ACC Agreement provides that ACC's stockholders will receive approximately that number of shares of TCG Class A Common Stock for each ACC share, equal to $50 divided by the average per share closing price of TCG Class A Common Stock for a ten-day trading period prior to closing of the transaction. In the event, however, that the average per share closing price of TCG Class A Common Stock during the ten-day trading period prior to closing is below $45, the exchange ratio is fixed at 1.11111 shares of TCG Class A Common Stock for each ACC share, and, if the average per share closing price of TCG Class A Common Stock during the ten-day trading period prior to closing is above $55, the exchange ratio is fixed at 0.90909 of a share of TCG Class A Common Stock for each ACC share. The total aggregate amount of consideration to be received by the ACC stockholders is expected to be approximately $1.0 billion.

At March 3, 1998, ACC was in the process of acquiring US WATS, Inc., ("US WATS") a domestic U.S. long distance reseller, and the US WATS acquisition was expected to be complete in early 1998.

TCG and ACC expect the transaction to be completed by mid-1998, subject to, among other things, approval by a majority of the holders of ACC's outstanding shares. Under the ACC Agreement, ACC has agreed not to solicit or take other actions with respect to any competing proposal, subject to compliance with fiduciary duties. ACC agreed to pay TCG $32.5 million, plus up to $7.5 million for expenses, if the ACC Agreement is terminated under certain circumstances.

Upon execution of the ACC Agreement, ACC amended its shareholder rights plan to exempt TCG from the 7.5% threshold by which the rights become exercisable. This amendment will remain in effect until December 31, 1998. In the event that the ACC Merger is completed, the underlying rights granted under the ACC shareholder rights plan will be redeemed by ACC.

Consummation of the ACC Merger is subject to certain closing conditions, including TCG and ACC obtaining required regulatory approvals and other related consents. Accordingly, there can be no assurance that the ACC Merger will be successfully consummated or, if successfully completed, when it might be completed.

Kansas City Fiber Network, L.P.

On December 1, 1997, TCG agreed to acquire the assets and customer base of Kansas City Fiber Network, L.P. ("KCFN"), a leading competitive local exchange carrier in the Kansas City metropolitan area owned by TCI and Time Warner Communications for approximately $55 million in cash and the assumption of certain liabilities. KCFN currently operates a fiber optic network over 580 route miles which connects to more than 200 on-net buildings. This acquisition is subject to approval from regulatory authorities which is expected in the second quarter of 1998. Effective as of June 1, 1997, TCG entered into a Technical Services Agreement with KCFN whereby TCG agreed to provide certain management services to KCFN. TCG has recorded the results of operations of KCFN subsequent to that date.

Pro Forma Financial Information

Unaudited pro forma financial information for the years ended December 31, 1997 and 1996 as if the TCG Reorganization and the acquisitions of ETC, CERFnet, BizTel, ACC (including US WATS), and KCFN had occurred at January 1, 1996, is as follows (in thousands, except share amounts):

	1997	1996
Revenue	$ 931,500	$ 670,312
Net loss	$ (238,279)	$ (167,652)
Loss per share	$ (1.26)	$ (0.96)
Weighted average number of shares outstanding	188,747,431	173,811,002

Pro forma adjustments for the year ended December 31, 1997 include the reversal of TCG's equity in the losses of ETC and BizTel as well as amortization of the intangible assets relating to the aforementioned acquisition. Pro forma adjustments for the year ended December 31, 1996 include (i) the reversal of TCG's equity in the losses of the 13 Local Market Partnerships and ETC, (ii) amortization of the intangible assets relating to the aforementioned acquisitions and (iii) the reduction of interest expense from the conversion of subordinated debt to parents to equity. The pro forma net loss for the year ended December 31, 1996 excludes the effect of the one-time nonrecurring charge for acquired in-process research and development. The pro forma financial information presented above is not necessarily indicative of the operating results which would have been achieved had the transactions occurred at the beginning of the periods presented or of the results to be achieved in the future.

Cox Fibernet Affiliates

Pursuant to the terms of three Operator Managed Ventures Services Agreements between TCG and certain affiliates of Cox, TCG has options to acquire up to a 35% interest in the competitive access business conducted by such affiliates of Cox in New Orleans, Oklahoma City and the Hampton Roads, Virginia area. To the extent the Cox competitive access provider has derived revenue from any contract entered into by TCG as a result of sales efforts engaged in by TCG on behalf of such Cox operations, the purchase price shall be the ratio of the annual TCG generated revenue to total annual revenue of the Cox operation multiplied by the book value of the assets of the Cox operation. If such ratio is less than 35%, TCG may purchase the balance, up to 35%, of that Cox operation for the fair market value (as determined in accordance with the Operator Managed Ventures Services Agreements) of the operation. There is no cap or maximum purchase price under the terms of the Operator Managed Ventures Services Agreements. In November 1996, TCG notified Cox of its intention to exercise its option to purchase a 35% interest in Cox's Hampton Roads, Virginia operations. The Company's options to acquire 35% interests in Cox's New Orleans and Oklahoma City operations do not mature until 1999. Cox and TCG engaged in discussions concerning the calculation of the purchase price formula for Hampton Roads, Virginia, and a possible renegotiation and restructuring of their respective rights and obligations of the parties under each of the Operator Managed Ventures Services Agreements. However, in connection with the AT&T Merger, Cox and TCG agreed to suspend their negotiations and to toll the option period until the later of six months after the effective time of the AT&T Merger and the contractual trigger date.

4. Marketable Securities

The following is a summary of TCG's marketable securities and cash equivalents at December 31, 1997 and 1996 (in thousands):

	1997			
	Amortized Cost	Unrealized Gain	Unrealized Loss	Market Value
Commercial paper	$124,246	$ 4	$ (4)	$124,246
Federal agency discount notes	33,750	—	(1)	33,749
Federal agency notes	54,524	9	(4)	54,529
Certificates of deposit	55,987	3	(6)	55,984
Corporate medium term notes	93,114	108	(2)	93,220
Corporate notes	15,000	39	—	15,039
Bank notes	19,993	18	—	20,011
	396,614	181	(17)	396,778
Less: Cash equivalents	89,950	—	—	89,950
Marketable securities	$306,664	$181	$ (17)	$306,828

	1996			
	Amortized Cost	Unrealized Gain	Unrealized Loss	Market Value
Commercial paper	$338,390	$ —	$ (83)	$338,307
U.S. Treasury bills	47,894	33	—	47,927
Federal agency notes	139,481	11	(29)	139,463
Corporate medium term notes	118,825	60	(33)	118,852
Floating rate notes	19,984	16	—	20,000
	664,574	120	(145)	664,549
Less: Cash equivalents	223,743	—	—	223,743
Marketable securities	$440,831	$120	$(145)	$440,806

The amortized cost and estimated fair value by maturity date as of December 31, 1997 is as follows (in thousands):

	Amortized Cost	Market Value
Due in one year	$313,490	$313,505
Due after one year through five years	83,124	83,273
Total	$396,614	$396,778

Proceeds from the sale of investments during 1997 and 1996 were $479.5 million and $664.8 million, respectively. Gross gains of $117 thousand and $57 thousand and gross losses of $13 thousand and $2 thousand were realized on these sales in 1997 and 1996, respectively. The change in the net unrealized holding gain from 1997 to 1996 on available-for-sale securities is $189 thousand.

5. Fixed Assets

The following is a summary of the Company's fixed assets as of December 31, 1997 and 1996 (in thousands):

	1997	1996
Communications network	$1,470,081	$ 875,152
Construction in progress	252,012	336,770
Other	150,990	92,307
	1,873,083	1,304,229
Less: Accumulated depreciation and amortization	(379,987)	(236,967)
Fixed assets—net	$1,493,096	$1,067,262

6. Long-Term Debt and Financial Instruments

Long-term debt outstanding as of December 31, 1997 and 1996 consisted of the following (in thousands):

	1997	1996
Senior Notes, 9.875%, due 2006	$ 300,000	$300,000
Senior Discount Notes, net of discount of $338,622 and $414,039 in 1997 and 1996, respectively, 11.125% due 2007	734,984	659,567
TCI Subordinated Note, 7.5% due 2001, repaid December 31, 1997	—	27,007
Total	$1,034,984	$986,574

All long-term debt matures subsequent to 2002.

Senior Notes and Senior Discount Notes

On July 2, 1996, TCG issued $300 million principal amount of Senior Notes due 2006 and $1,073 million aggregate principal amount at maturity of Senior Discount Notes due 2007 (collectively the "Notes"). The Senior Notes were issued pursuant to an indenture (the "Senior Notes Indenture") between TCG and the United States Trust Company of New York, as trustee, and the Senior Discount Notes were issued pursuant to an Indenture (the "Senior Discount Notes Indenture" and, together with the Senior Notes Indenture, the "Indentures") between the Company and the United States Trust Company of New York, as trustee. The Indentures contain certain restrictive covenants which impose limitations on TCG and certain of its subsidiaries' ability to, among other things: (i) incur additional indebtedness, (ii) pay dividends or make certain other distributions and investments, (iii) create liens, (iv) create dividend and other payment restrictions on subsidiaries, (v) incur certain guarantees, (vi) enter into certain asset sale transactions, (vii) enter into certain transactions with affiliates (including the Cable Stockholders) and (viii) merge, consolidate or transfer substantially all of the Company's assets. Under the terms of the Indentures, TCG currently is not able to pay dividends. TCG is currently in compliance with the terms of these covenants.

The Senior Discount Notes were issued at a discount to their aggregate principal amount to generate gross proceeds of approximately $625 million. The Senior Discount Notes accrete at a rate of 11.125% compounded semi-annually, to an aggregate principal amount of $1,073 million by July 1, 2001. Thereafter, interest on the Senior Discount Notes will accrue at the rate of 11.125% per annum and will be payable semi-annually on January 1 and July 1, commencing on January 1, 2002; provided that at any time prior to July 1, 2001, TCG

may elect to commence the accrual of cash interest on the Senior Discount Notes, in which case the outstanding principal amount on such Notes will be reduced to their accreted value as of the date of such election and cash interest shall become payable thereafter.

The Notes will be subject to redemption at the option of TCG, in whole or in part, at any time on or after July 1, 2001, initially at 104.938% of their principal amount in the case of the Senior Notes, and 105.563% in the case of the Senior Discount Notes and declining to 100% of their principal amount on or after July 1, 2004, in all cases plus accrued and unpaid interest thereon to the applicable redemption date. The incurrence of long-term indebtedness by TCG is subject to approval by the New York Public Service Commission (the "NYPSC") and the New Jersey Board of Public Utilities (the "NJPBU"). Both the NYPSC and NJBPU have authorized TCG to issue long-term debt in amounts not to exceed $4 billion.

The fair value of TCG's long-term debt is estimated based on the quoted market price for the same or similar issues or on borrowing rates currently available to TCG for debt with similar terms and maturities. The fair value of TCG's long-term debt was $1.2 billion and $1.1 billion at December 31, 1997 and 1996, respectively. The total interest expense for the Notes was $105.0 million and $49.3 million for the years ended December 31, 1997 and 1996, respectively.

The Revolving Credit Agreement

On May 22, 1995, TCG entered into a Loan Agreement (the "Revolving Credit Agreement") with Toronto Dominion (Texas), Inc., as administrative agent, Chemical Bank, as documentation agent, and the Banks (as defined in the Revolving Credit Agreement) to finance capital expenditures and working capital needs of TCG's subsidiaries and of the Local Market Partnerships and to repay debt of TCG and its subsidiaries to the Cable Stockholders. Borrowings of $250 million were utilized for the growth of TCG. The $250 million of indebtedness under the Revolving Credit Agreement was repaid in July 1996 from the proceeds of the 1996 Offerings.

On July 28, 1997, TCG, through a wholly-owned subsidiary, TCG New York, Inc. ("TCGNY") amended its $250 million Revolving Credit Agreement to a $400 million Revolving Credit Agreement (the "Revolving Credit Agreement"). The Revolving Credit Agreement is secured by (i) the stock of the following wholly-owned subsidiaries of TCGNY: TC New York Holdings I, Inc., TC New York Holdings II, Inc., TC Systems, Inc., TCG Payphones, Inc. and the partnership interests in Teleport Communications, (ii) a negative pledge with respect to the assets and a pledge of the stock of each existing and future subsidiary of TCGNY, (iii) a negative pledge with respect to the contracts that relate to TCGNY operations, (iv) upstream guarantees from any existing and future subsidiaries of TCGNY, and (v) a lien on all present and future intercompany indebtedness owed to TCGNY from TCG and all of its subsidiaries. The Revolving Credit Agreement provides for interest based upon either the base rate or London Interbank Offered Rate ("LIBOR"), adjusted as defined in the Revolving Credit Agreement. In addition, TCGNY must pay a commitment fee equal to 0.375% per annum on the unused commitment amount. There was no outstanding balance as of December 31, 1997 and 1996. The total interest expense for amounts borrowed and commitment fees under the Revolving Credit Agreement were $1.2 million, $6.3 million and $3.0 million for the years ended December 31, 1997, 1996 and 1995, respectively. At December 31, 1997, the amount available under the Revolving Credit Agreement was $344.4 million.

The commitment will be reduced in equal quarterly installments according to the following schedule:

Year	Amount (in millions)
2000	$ 12.5
2001	35.0
2002	55.0
2003	70.0
2004	90.0
2005	100.0
2006	37.5
	$400.0

The shares of capital stock owned by TCG in certain of the wholly-owned subsidiaries of TCG (TC New York Holdings I, Inc., TC New York Holdings II, Inc., TCG Payphones, Inc., and TC Systems, Inc., collectively the "Restricted Subsidiaries") were and remain pledged as collateral to secure loans pursuant to, and may not be pledged to any other party under the terms of, the Revolving Credit Agreement.

In December 1995, the capital stock of the wholly-owned Restricted Subsidiaries of TCG was transferred, subject to the pledge, to TCG New York, Inc., a wholly-owned subsidiary of TCG. TCG New York, Inc. assumed all obligations under the Revolving Credit Agreement as of the date of transfer. TCG New York, Inc. is permitted under the terms of the Revolving Credit Agreement to advance funds to TCG. When made, such advances are to be evidenced by notes from TCG to TCG New York, Inc. which will be pledged as collateral under the Revolving Credit Agreement.

The Revolving Credit Agreement contains various covenants and conditions, including restrictions on additional indebtedness, maintenance of certain financial ratios and limitations on capital expenditures. TCG is currently in compliance with the terms of these covenants. None of these covenants negatively impact TCG's liquidity or capital resources at this time.

In 1995, TCG entered into interest rate swap agreements to mitigate the impact of changes in interest rates on its long-term bank debt. TCG had no interest rate swaps with commercial banks at December 31, 1997 and 1996. The average fixed interest rate was 5.93% in 1995. These agreements effectively fixed TCG's interest rate exposure on various LIBOR based floating rate notes (which ranged from 5.87% to 5.94%). During July 1996, TCG repaid $250 million of bank indebtedness with the proceeds of the 1996 Offerings. Due to this repayment, TCG is not currently required under its Revolving Credit Agreement to enter into interest rate swap arrangements. Accordingly, during 1996, TCG terminated four interest rate swap arrangements which were due to mature in 1997, for a gain of approximately $1.5 million.

TCI Subordinated Note

In connection with the 1996 Offerings, the Cable Stockholders contributed to TCG $269.0 million aggregate principal amount of indebtedness, plus accrued interest from May 1995, except that TCI retained a $26 million subordinated note of TCG, in exchange for Class B Common Stock issued to the Cable Stockholders. The loan agreement was terminated in connection with the TCG Reorganization. Interest and principal on the TCI Subordinated Note were payable in 2001. The TCI Subordinated note was repaid on December 31, 1997 at a discounted value of approximately $25.1 million.

Cable Stockholders Loan Agreement

TCG had a loan agreement with the Cable Stockholders aggregating $349.6 million ($269.0 million outstanding at December 31, 1995). Borrowings bore interest at 75 basis points above the one-month London Interbank Offered Rate ("LIBOR"). Total interest expense for this loan was $0, $8.4 million and $17.6 million for the years ended December 31, 1997, 1996 and 1995, respectively.

ETC Facility

In the acquisition of ETC, TCG assumed ETC's credit facility which was entered into in October 1995 with CoreStates Bank, N.A. and certain other lenders (the "ETC Facility"). The ETC Facility is a $60.0 million credit facility. The ETC Facility provides for interest based upon either the base rate, or LIBOR, adjusted as defined in the ETC Facility (7.4375% at December 31, 1997), which is payable quarterly. The balance outstanding is due on September 30, 1998. Borrowings under the ETC Facility are collateralized by substantially all of the assets and outstanding common stock of TCG Delaware Valley, Inc. In addition, the ETC Facility contains certain restrictive covenants which, among other things, require TCG Delaware Valley to maintain certain debt service coverage ratios and limit the payment of dividends and capital expenditures. TCG is currently in compliance with terms of these covenants. In addition, TCG Delaware Valley is required to pay .375% per year on the available portion of the ETC Facility. The total outstanding balance at December 31, 1997, was $52.6 million.

7. Stockholders' Equity

1997 Equity Offering

Continental acquired its interest in TCG in May 1993. On November 15, 1996, Continental was acquired by U S WEST. In connection with such acquisition, on November 5, 1996, the U.S. Department of Justice announced, and on February 28, 1997, a final judgment was entered (the "Final Judgment") with respect to a settlement with U S WEST and Continental pursuant to which Continental was required to reduce its ownership in TCG below 10% by June 30, 1997, and was required to eliminate such ownership entirely by December 31, 1998. On February 19, 1997, pursuant to the Amended and Restated Stockholders' Agreement dated June 26, 1996, between TCG and the Cable Stockholders (the "Amended Stockholders' Agreement"), Continental converted 4,000,000 shares of Class B Common Stock into 4,000,000 shares of Class A Common Stock and, in accordance with the provisions of Rule 144 promulgated by the Commission under the Securities Act, transferred these shares to one or more third parties. Thereafter, Continental converted an additional 4,500,000 shares of Class B Common Stock, pursuant to the Amended Stockholders' Agreement, and in accordance with the provisions of Rule 144 transferred 3,840,000 of such shares to one or more third parties.

TCG filed a registration statement for a public offering (the "1997 Equity Offering") of 17,250,000 shares of Class A Common Stock on October 10, 1997, and the 1997 Offering was consummated on November 13, 1997. Of the 17,250,000 shares, 7,304,408 were offered by the Company and 9,945,592 shares were offered by Continental. The Company did not receive any proceeds from the sale of shares by Continental. The net proceeds to the Company from its sale of shares pursuant to the 1997 Equity Offering were approximately $317.4 million, after deducting the underwriting discount and expenses of approximately $11.3 million.

8. Employee Benefit Plans

Teleport Communications Group Retirement Savings Plan—TCG has a Retirement Savings Plan (the "Plan") with a retirement savings component covering substantially all eligible employees of TCG with one or more years of service and a 401(k) savings component covering substantially all eligible employees of TCG. Under the retirement component of the Plan, TCG contributes an amount based on years of service and annual

eligible compensation. Under the 401(k) component of the Plan, participants may make pre-tax contributions and TCG matches 50% of the first 6% of annual eligible compensation to a maximum company contribution of $1,500 per employee for employees with more than one year of service. Participants with less than one year of service may make pre-tax contributions without a company match.

Effective November 1, 1996, the Plan offers TCG's Class A Common Stock as an investment option. The Plan purchases shares on the open market. As of December 31, 1997 and 1996, respectively, 113,553 and 36,186 shares, with a total market value of $6.2 million and $1.1 million, had been purchased under the Plan.

In 1997, 1996 and 1995, TCG made matching contributions of $1.5 million, $1.1 million, and $0.7 million, respectively, as required by the 401(k) component and $2.2 million, $1.4 million, and $1.0 million, respectively, under the retirement component of the plan.

TCG has established a non-qualified, funded, deferred compensation Make-Up Plan of Teleport Communications Group Inc. (the "Make-Up Plan") for the Teleport Communications Group Inc. Retirement Savings Plan. The purpose of the Make-Up Plan is to provide certain eligible participants benefits which would have been payable under the Retirement Savings Plan, but were limited by the maximum company match of $1,500, as well as compensation limits set forth by the IRS. Expenses incurred in connection with the Make-Up Plan were approximately $0.9 million in 1997 and were insignificant in 1996 and 1995.

Teleport Communications Group Unit Appreciation Plan—TCG has established the Teleport Communications Group Unit Appreciation Plan (the "UAP") for 1992 and 1993. During the years ended December 31, 1993 and 1992, TCG made awards of deferred compensation in the form of units (the "Units"), pursuant to the UAP, to certain eligible employees of TCG. Benefits under the UAP are equal to the value of the Units on the date the employee terminates employment or is fully vested in the Units, less the initial base price of the Units. The initial base price of each Unit as of January 1, 1993 and 1992 was $34.85 and $30.00, respectively. Each Unit is equal to 8.4 shares of Class A Common Stock. Except for awards to a certain employee, the appreciation of any Unit is limited to 200% of the initial base price. Pursuant to an employee's employment agreement, there is no limit on the appreciation he may receive under the 1992 UAPs. Awards under the UAP are subject to a five-year vesting schedule, pursuant to which the Units granted were 60% vested as of December 31, 1995 and December 31, 1994, respectively, and fully vested no later than December 31, 1997 and December 31, 1996, respectively, subject to certain exceptions provided therein. The 1992 UAPs were fully vested December 31, 1996 and were paid early in 1997. In connection with the UAP, TCG recognized compensation expense of $15 thousand, $1.4 million and $2.5 million for the years ended December 31, 1997, 1996 and 1995, respectively. In January 1996, TCG adopted a plan which permits the awards under the UAP to be deferred in whole or in part at the election of the participants for periods of up to five years or, with the Administrative Committee's consent, until termination of employment.

The following table provides additional information concerning the Unit Appreciation Plan awards:

Year of Award	Initial Number of Units	Number of Units Outstanding at December 31, 1997	Number of Units Vested at December 31, 1997	Value of Units Vested at December 31, 1997	Number of Units Outstanding at December 31, 1996	Number of Units Vested at December 31, 1996	Value of Units Vested at December 31, 1996	Number of Units Outstanding at December 31, 1995
1993	36,000	5,300	5,300	$369,410	5,300	4,240	$ 295,528	23,700
1992	170,850	—	—	—	63,250	63,250	7,695,373	139,200
Total	206,850	5,300	5,300	$369,410	68,550	67,490	$7,990,901	162,900

Teleport Communications Group Inc. 1996 Equity Incentive Plan—TCG established the Teleport Communications Group Inc. 1996 Equity Incentive Plan (the "Equity Incentive Plan") effective June 27, 1996, to provide opportunities for certain employees of TCG to participate in the appreciation in the value of TCG after the initial public offering. The Board of Directors authorized the issuance of up to 637,792 shares of Class A Common Stock under the Equity Incentive Plan. The Equity Incentive Plan is administered by the Compensation Committee which has full and discretionary power to award shares under the Equity Incentive Plan.

Under the Equity Incentive Plan, each employee who had an award under the 1992 UAP or the 1993 UAP, whether or not the employee had elected to defer receipt of the payment of benefits thereunder and who is employed by TCG as of June 27, 1996, had the right to waive his/her interest in all or any portion of the employee's benefit in the 1992 UAP or the 1993 UAP. In exchange therefore, the employee was granted a number of shares under the Equity Incentive Plan equal to the value of the portion of the employee's benefit waived (determined as of June 27, 1996) multiplied by 120% and divided by the initial public offering price per share of Class A Common Stock. No employee could receive more than 54,000 shares under the Equity Incentive Plan, and a certain employee was not eligible to participate. One share under the Equity Incentive Plan is equivalent in value to one share of Class A Common Stock. Thus, the value of the benefit payable under the Equity Incentive Plan will fluctuate in accordance with the fair market value of the Class A Common Stock.

Shares under the Equity Incentive Plan granted in exchange for 1992 UAP benefits are subject to a two-year vesting schedule, with 70% of the shares becoming vested as of June 27, 1997 and the remaining 30% becoming vested as of the June 27, 1998. Shares granted in exchange for the 1993 UAP benefits are subject to a three-year vesting schedule, with 70% of the shares becoming vested as of June 27, 1998 and the remaining 30% becoming vested as of June 27, 1999. A participant shall become 100% vested in his/her shares in the event of death, total disability or a change in control. In the event a participant's employment is terminated for cause, his/her interest in each and every share awarded under the Equity Incentive Plan shall be forfeited.

Shares under the Equity Incentive Plan will be paid to a participant either in one lump sum cash payment or in shares of Class A Common Stock, as determined at the discretion of the Compensation Committee, on the payment date elected by the participant at the time he/she elects to participate in the Equity Incentive Plan. In general, the payment date elected may be the last business day of any calendar quarter during the period commencing June 30, 1998 and ending June 30, 2001.

At December 31, 1997 and 1996, respectively, 409,983 and 421,233 shares were outstanding under the Equity Incentive Plan.

Teleport Communications Group Inc. Stock Option Plan—TCG established the Teleport Communications Group Stock Option Plan (the "SOP") effective September 26, 1993. The SOP is administered at the discretion of the Compensation Committee, which has made long-term incentive compensation awards in the form of non-qualified and incentive stock options to eligible employees. Stock options were granted with exercise prices at or above the fair market value of the shares on the date of grant, and no compensation expense has been recognized in connection with the options. The Compensation Committee may permit the exercise price to be paid in cash, through delivery of other shares of Class A Common Stock, by delivering irrevocable instructions to a financial institution to deliver promptly to TCG the portion of sale or loan proceeds sufficient to pay the exercise price, or through an election to have shares withheld from the shares otherwise to be received by the option holder.

The following table provides additional information concerning the SOP:

	Shares of Common Stock		
	Available for Grant	Outstanding	Exercise Price
Balance, January 1, 1995	2,888,046	2,495,304	$ 6.90—10.39
Authorized	—	—	—
Granted	(285,096)	285,096	14.22
Exercised	—	(27,115)	6.90
Forfeited	215,225	(215,225)	6.90—14.22
Balance, December 31, 1995	2,818,175	2,538,060	$ 6.90—14.22
Authorized	5,547,683	—	—
Granted	(2,003,462)	2,003,462	17.46—21.60
Exercised	—	(55,355)	6.90
Forfeited	173,443	(173,443)	6.90—21.60
Balance, December 31, 1996	6,535,839	4,312,724	$ 6.90—21.60
Authorized	—	—	—
Granted	(1,935,068)	1,935,068	24.48—55.02
Exercised	—	(285,332)	6.90—10.39
Forfeited	155,944	(155,944)	6.90—49.00
Balance, December 31, 1997	4,756,715	5,806,516	$ 6.90—55.02

Teleport Communications Group Inc. Employee Stock Purchase Plan (1997)—TCG adopted the Teleport Communications Group Inc. Employee Stock Purchase Plan (the "1997 Stock Purchase Plan"), effective July 1, 1997. The 1997 Stock Purchase Plan is administered by the Compensation Committee of the Board of Directors (the "Committee"). As of the first day of each calendar quarter each eligible employee will be granted the option to purchase as of the last day of each calendar quarter, a number of shares determined under a uniform formula specified by the Committee. Each eligible employee was given an option to purchase the number of shares equal to 10% of such employee's compensation plus bonus paid in that calendar quarter, divided by the purchase price per share under the option. No employee can receive options for more than $25,000 worth of shares in any calendar year. The purchase price for one share of Class A Common Stock is 15% below the average closing price of the last ten trading days of the calendar quarter. The Committee authorized the issuance of 1,500,000 shares of Class A Common Stock under the 1997 Stock Purchase Plan. The expense recorded for the year ended December 31, 1997 related to options issued was approximately $0.3 million.

Teleport Communications Group Inc. Employee Stock Purchase Plan (1996)—TCG adopted the Teleport Communications Group Inc. Employee Stock Purchase Plan (the "1996 Stock Purchase Plan"), effective June 27, 1996. The 1996 Stock Purchase Plan is administered by the Committee. Each eligible employee was given an option to purchase a number of shares of Class A Common Stock up to 10% of such employee's compensation plus bonus paid for the calendar year preceding the year the option is awarded, divided by the purchase price per share under the option. No employee can receive options for more than $25,000 worth of shares in any calendar year. The purchase price for one share of Class A Common Stock is 15% below the initial offering price of $16, or $13.60. The Board of Directors has authorized the issuance of 745,000 shares under the 1996 Stock Purchase Plan. The options expired on June 27, 1997. Options related to 584,686 shares of Class A Common Stock were exercised.

The expense recorded in each of the years ended December 31, 1997 and 1996 related to the options issued was approximately $0.7 million.

The following table provides additional information concerning the 1996 and 1997 Employee Stock Purchase Plans:

	Shares of Common Stock		
	Available for Grant	Outstanding	Exercise Price
Balance, January 1, 1996	—	—	$ —
Authorized	745,000	—	13.60
Granted	(623,894)	623,894	13.60
Exercised	—	—	—
Forfeited	41,001	(41,001)	13.60
Balance, December 31, 1996	162,107	582,893	$ 13.60
Authorized	1,500,000	—	—
Granted	(109,975)	109,975	35.54
Exercised	—	(609,651)	13.60—35.54
Forfeited	83,217	(83,217)	13.60
Balance, December 31, 1997	1,635,349	—	$ —

Stock-Based Compensation—In October 1995, the FASB issued SFAS No. 123, "Accounting for Stock-Based Compensation" which encourages but does not require companies to record compensation cost for stock-based compensation plans at fair value.

TCG has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion ("APB") No. 25 "Accounting for Stock Issued to Employees," and its related interpretations. Accordingly, no compensation expense has been recorded for its stock awards and employee stock purchase plans, but rather, the Company has determined the pro forma net loss and net loss per share amounts for 1997, 1996 and 1995, as if compensation expense had been recorded for options granted during those years under the fair value method described in SFAS No. 123. Compensation cost for stock options is measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock. Compensation cost for stock appreciation rights and performance equity units is recorded quarterly based on the quoted market price of TCG's stock at the end of the period.

The Company utilized the Black-Scholes option pricing model to estimate the fair value at the date of grant of options granted during 1997, 1996 and 1995. Under the Black-Scholes model, the volatility factor ranged from 25.0% to 26.4% was used for options granted on or after the date of the 1996 Offerings and the minimum value method was used for options granted prior to the date of the 1996 Offerings, as if there was no market for the Company's common stock in which to monitor stock price volatility. Had TCG adopted SFAS No. 123, net loss and loss per share would have increased as indicated below (in thousands, except share amounts):

	1997	1996	1995
Net loss—as reported	$ (222,667)	$ (114,850)	$ (53,804)
Net loss—pro forma	$ (225,625)	$ (116,398)	$ (53,929)
Loss per share—as reported	$ (1.34)	$ (1.00)	$ (0.77)
Loss per share—pro forma	$ (1.36)	$ (1.02)	$ (0.77)
Weighted average number of shares outstanding	165,728,059	114,443,695	70,000,140

Valuation Assumptions—The fair value of options at the date of grant was established using the Black-Scholes model with the following weighted average input assumptions:

	Expected Life	Exercise Price	Stock Price at Grant	Volatility	Risk Free Int. Rate	Div. Yield	Annual Forfeiture Rate
1996 Employee Stock Purchase Plan Grants.....	1.00	$13.60	$16.00	25.0%	5.81%	0%	4.89%
1995, 1996 and 1997 Stock Option Grants	5.00 to 7.00	$14.22 to $46.98	$14.22 to $46.98	0.1% to 26.4%	5.80% to 6.73%	0%	0% to 5.00%

The following table summarizes information concerning the remaining options outstanding as of December 31, 1997 for the 1997, 1996 and 1995 option grants and the 1997 Employee Stock Purchase Plan:

	Options Outstanding				Options Exercisable	
	Range of Exercise Prices	Number of Shares Outstanding	Weighted Avg. Remaining Contractual Life	Weighted Average Exercise Prices	Number of Shares Exercisable	Weighted Average Exercise Prices
1995, 1996 and 1997 Stock Option Grants and 1997 Employee Stock Purchase Plan	$14.22 to $55.02	4,011,154	5.00 to 7.00	$14.22 to $46.98	2,313	$14.22

Employment Agreements—TCG has employment agreements with certain of its executive officers and senior management personnel. These agreements are effective through dates ending from June 30, 1998 to December 31, 2000, unless terminated earlier by the executive or TCG, and provide for annual salaries, cost-of-living adjustments, additional compensation in the form of bonuses based on the performance of TCG and the executive, and participation in the various benefit plans of TCG. The agreements contain certain benefits to the executive if TCG terminates the executive's employment without cause or if the executive terminates his employment as a result of change in ownership of TCG. The salary and bonus expense related to these employment agreements for the years ended December 31, 1997, 1996 and 1995 approximated $3.6 million, $2.9 million and $2.1 million, respectively. TCG's remaining aggregate commitments for salaries under such agreements is approximately $4.9 million. The commitments for bonuses under these agreements is approximately $1.9 million.

In the event TCG terminates the executive without cause or the executive terminates his/her employment as a result of a change in control, the agreements provide for continued vesting in deferred compensation and long term incentive awards as well as the payment of a base salary for each executive plus an annual bonus for the duration of the agreement. The annual bonus is an amount not less than 30% of such base salary, except for a certain employee whose minimum annual bonus is 50% of base salary. Each executive is entitled to these severance benefits for at least six months following such termination, except for a certain employee whose minimum entitlement period is 30 months.

9. Income Taxes

There are no current income taxes payable based on TCG's operating loss. The current state and local tax expense are based on factors other than income. The following temporary differences compose the net deferred income tax payable (in thousands):

	1997	1996
Deferred income tax liabilities:		
Depreciation, amortization and excess credits	$ 73,868	$ 43,072
Other	553	—
	74,421	43,072
Deferred income tax assets:		
Operating loss	(192,433)	(81,578)
Deferred revenue	(2,403)	(2,361)
Assets recorded for tax purposes	(3,575)	(3,368)
Incentive compensation	(6,434)	(4,579)
Equity in losses of unconsolidated subsidiaries	(142)	(138)
Other	(248)	—
	(205,235)	(92,024)
Less: valuation allowance	131,778	49,874
Total deferred tax assets	(73,457)	(42,150)
Deferred income taxes payable—net	$ 964	$ 922

In 1997, 1996 and 1995, the net income tax benefits of approximately $81.9 million, $29.6 million and $10.9 million, respectively, have been offset by increases in the valuation allowance of $81.9 million, $29.6 million and $10.9 million, respectively, due to the uncertainty of realizing the benefit of the loss carry-forwards.

At December 31, 1997, TCG had operating loss carry-forwards for federal income tax purposes of approximately $523.0 million, expiring principally in 2003 through 2013. Approximately $49.0 million of the net operating loss carryforwards are carryovers related to the acquisitions of BizTel and ETC. The net operating losses related to these acquisitions will be subject to various limitations.

A reconciliation of the statutory federal income tax rate and TCG's effective income tax rate is as follows:

	1997	1996	1995
Statutory federal income tax rate	35.00%	35.00%	35.00%
State and local taxes, less federal benefit	0.75	2.36	1.30
Unutilized tax benefit due to net operating loss	(30.04)	(31.80)	(33.30)
Permanent differences and other	(4.96)	(3.20)	(1.70)
Effective rate	0.75%	2.36%	1.30%

10. Related Party Transactions

In 1996 TCG entered into a preliminary agreement with TCI which provided for the provision of certain services by TCG to TCI in connection with the development by TCI of residential telephony service offerings in Hartford, Connecticut, Fremont, California and Arlington Heights, Illinois. TCI has agreed to reimburse TCG