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

FORM 10-Q

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

For the quarterly period ended June 30, 2005

OR

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

Commission File No. 0-30900

XO Communications, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**54-1983517**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. employer identification no.)**

11111 Sunset Hills Road
Reston, Virginia 20190
(Address of principal executive offices, including zip code)
(703) 547-2000
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined by Rule 12b-2 of the Exchange Act.). YES þ NO o

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13, or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. YES þ NO o

As of August 8, 2005, the number of shares of common stock of XO Communications, Inc. issued and outstanding was 181,933,035.

XO Communications, Inc. and Subsidiaries

Index to Form 10-Q

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

XO Communications, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets
(Amounts in thousands, except for share and per share data)

	June 30, 2005 (Unaudited)	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 270,143	$ 233,989
Marketable securities and other investments	9,455	17,300
Accounts receivable, net of allowance for doubtful accounts of $37,145 at June 30 , 2005 and $38,981 at December 31, 2004, respectively	137,683	150,101
Other current assets	33,121	50,864
Total current assets	450,402	452,254
Property and equipment, net	764,729	820,536
Broadband wireless licenses and other intangibles, net	115,567	139,866
Other assets, net	44,917	46,729
Total assets	$1,375,615	$1,459,385
LIABILITIES, CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 86,055	$ 88,010
Other current liabilities	225,073	241,532
Total current liabilities	311,128	329,542
Long-term debt and accrued interest payable	382,646	366,247
Other long-term liabilities	67,502	73,691
Total liabilities	761,276	769,480
Class A convertible preferred stock	210,596	204,353
Commitments and contingencies		
Stockholders' equity:		
Preferred stock: par value $0.01 per share, 200,000,000 shares authorized: 4,000,000 shares of Class A convertible preferred stock issued and outstanding on June 30 , 2005 and December 31, 2004	—	—
Warrants and common stock, par value $0.01 per share, 1,000,000,000 shares authorized: 181,933,035 shares issued and outstanding on June 30 , 2005 and December 31, 2004	983,268	989,511
Deferred compensation	(463)	(574)

Accumulated other comprehensive income	1,400	4,712
Accumulated deficit	(580,462)	(508,097)
Total stockholders’ equity	403,743	485,552
Total liabilities, convertible preferred stock and stockholders’ equity	$1,375,615	$1,459,385

See accompanying notes to the unaudited condensed consolidated financial statements.

XO Communications, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations
(Amounts in thousands, except for share and per share data)
(Unaudited)

	Three months ended June 30, 2005	Three months ended June 30, 2004
Revenue	$ 362,164	$ 278,183
Costs and expenses:		
Cost of service (exclusive of depreciation and amortization)	138,024	118,822
Selling, operating, and general	187,772	164,149
Depreciation and amortization	61,097	30,065
Total costs and expenses	386,893	313,036
Loss from operations	(24,729)	(34,853)
Interest income	1,919	841
Investment gain (loss), net	1,891	(3,962)
Interest expense, net	(8,588)	(5,846)
Net loss	$ (29,507)	$ (43,820)
Preferred stock accretion	(3,145)	—
Net loss applicable to common shares	$ (32,652)	$ (43,820)
Net loss per common share, basic and diluted	$ (0.18)	$ (0.31)
Weighted average shares, basic and diluted	181,933,035	140,538,159

See accompanying notes to the unaudited condensed consolidated financial statements.

XO Communications, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations
(Amounts in thousands, except for share and per share data)
(Unaudited)

	Six months ended June 30, 2005	Six months ended June 30, 2004
Revenue	$ 723,669	$ 539,128
Costs and expenses:		
Cost of service (exclusive of depreciation and amortization)	285,947	228,783
Selling, operating, and general	379,466	332,702
Depreciation and amortization	119,461	55,762
Total costs and expenses	784,874	617,247
Loss from operations	(61,205)	(78,119)
Interest income	3,820	2,546
Investment gain (loss), net	1,612	(4,291)
Interest expense, net	(16,592)	(12,450)
Net loss	$ (72,365)	$ (92,314)
Preferred stock accretion	(6,242)	—
Net loss applicable to common shares	$ (78,607)	$ (92,314)
Net loss per common share, basic and diluted	$ (0.43)	$ (0.67)
Weighted average shares, basic and diluted	181,933,035	137,591,467

See accompanying notes to the unaudited condensed consolidated financial statements.

XO Communications, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows
(Amounts in thousands)
(Unaudited)

	Six months Ended June 30, 2005	Six months Ended June 30, 2004
OPERATING ACTIVITIES:		
Net loss	$ (72,365)	$ (92,314)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	119,461	55,762
Accrual of interest	16,399	12,886
Stock-based compensation	111	226
Realized loss on investments	3,191	5,665
Changes in assets and liabilities:		
Accounts receivable	12,418	(23,115)
Other assets	(5,875)	(15,198)
Accounts payable	(1,781)	9,118
Accrued liabilities	(21,123)	(7,722)
Net cash provided by (used in) operating activities	50,436	(54,692)
INVESTING ACTIVITIES:		
Capital expenditures, net	(39,529)	(49,124)
Acquisition payments	—	(361,517)
Sales of marketable securities and investments	1,342	21,144
Release of escrow account	25,430	—
Net cash used in investing activities	(12,757)	(389,497)
FINANCING ACTIVITIES:		
Repayments of long term debt and capital leases	(1,525)	(198,363)
Proceeds from issuance of common stock	—	197,612
Proceeds from exercise of stock options	—	2,714
Net cash (used in) provided by financing activities	(1,525)	1,963
Net increase (decrease) in cash and cash equivalents	36,154	(442,226)
Cash and cash equivalents, beginning of period	233,989	478,560
Cash and cash equivalents, end of period	$270,143	$ 36,334
SUPPLEMENTAL DATA:		
Cash paid for interest	$ 1,539	$ 1,140

Stock issued for acquired businesses	$ —	$ 311,307

See accompanying notes to condensed consolidated financial statements.

XO Communications, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements
(Unaudited)

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Overview

XO Communications Inc. (“XOC”), a Delaware corporation, through its subsidiaries (collectively referred to as the “Company” or “XO”), owns and operates an integrated metropolitan and nationwide fiber optic network that provides a comprehensive array of telecommunications services to business customers in over 70 United States markets. Voice services include local and long distance services, calling card and interactive voice response systems. Data services include Internet access, private data networking and hosting services. XOC, through its subsidiaries, also offers integrated combined voice and data services in flat rate “bundled” packages. In addition, XO owns licenses to deliver telecommunications services via local multipoint distribution service, or LMDS, wireless spectrum in 75 U.S. cities, which we have begun to use to provide fixed broadband wireless backhaul services to mobile wireless telecommunications carriers. The consolidated financial statements include the accounts and activities of XOC and its subsidiaries.

Basis of Presentation

The condensed consolidated financial statements of the Company are unaudited and have been prepared in accordance with guidelines established for interim financial statements by the Securities and Exchange Commission’s (the “Commission”) instructions to Form 10-Q and U.S. generally accepted accounting principles. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements.

Operating results for any interim period are not necessarily indicative of the results for a full year or for any subsequent interim period. In the opinion of management, the unaudited condensed consolidated financial statements contain all the adjustments (consisting of those of a normal recurring nature) considered necessary to present fairly the financial position and the results of operations and cash flows for the periods presented in conformity with accounting principles generally accepted in the United States applicable to interim periods. The accompanying financial statements should be read in conjunction with the audited consolidated financial statements of XO, included in its Annual Report on Form 10-K for the year ended December 31, 2004 (the “2004 Annual Report”).

On June 23, 2004 (the “Closing Date”), XO completed the acquisition of all of the telecommunications services assets (the “Acquired Businesses”) of Allegiance Telecom, Inc. (“Allegiance”). XO did not acquire Allegiance’s customer premises installation and maintenance business, shared hosting business, or dedicated dial-up Internet access service business (the “Unacquired Businesses”). The accompanying financial statements include the results of operations from the Acquired Businesses since June 23, 2004.

Principles of Consolidation

The Company’s consolidated financial statements include all of the assets, liabilities and results of operations of subsidiaries in which the Company has a controlling interest. All inter-company accounts and transactions among consolidated entities have been eliminated.

Use of Estimates and Assumptions

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States 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 consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Management periodically assesses the accuracy of these estimates and assumptions. Actual results could differ from those estimates.

In the first and second quarter of 2005, the Company resolved certain billing disputes with telecommunications service providers (the "Carriers"). In accordance with the Company's policy for disputed charges, all amounts billed by the Carriers had previously been recorded as a cost of service in the Company's Condensed Consolidated Statement of Operations. Because these disputes were resolved favorably to the Company, they resulted in a reduction of cost of service of approximately $10.0 million and $10.5 million during the first and second quarters of 2005, respectively. Additionally, in the second quarter of 2005, the Company revised estimates related to liabilities assumed in relation to the Acquired Businesses. These revisions resulted in a reduction to cost of service of $3.9 million.

Reclassifications

Certain reclassifications have been made to prior period amounts in order to conform to the current year presentation.

Adjustments

In the second quarter of 2005, in conjunction with a review of certain accounting policies, the Company determined that it was not applying the proper generally accepted accounting principles to lease escalation provisions contained in certain of its operating leases since its emergence from bankruptcy in January 2003. Additionally, the Company determined that depreciation expense related to certain assets had been calculated using lives inconsistent with the Company's depreciation policy, and that certain leasehold improvements had not been expensed when the related lease contract had been terminated prior to the end of the original lease term. Accordingly, an adjustment of $8.3 million was recorded to increase selling, operating and general expenses and other current liabilities, and an adjustment of $2.5 million was recorded to increase depreciation expense and to reduce Property and Equipment, net during the three months ended June 30, 2005. The impact of these adjustments would have increased selling operating and general expense by approximately $4.5 million, $3.3 million, and $0.5 million for the years ended December 31, 2003, December 31, 2004 and the three months ended March 31, 2005, respectively, and would have increased depreciation expense by approximately $0.5 million, $1.0 million, and $1.0 million for the years ended December 31, 2003, December 31, 2004 and the three months ended March 31, 2005, respectively, had they been recorded in the appropriate periods. The Company has concluded that these adjustments are immaterial to the financial statements on both a quantitative and qualitative basis for previously issued financial statements, and to the estimated results of operations for the year ending December 31, 2005. Accordingly, the adjustments have been made in the current period financial statements. These adjustments do not affect the Company's historical or future cash flows or the timing of payments under the relevant leases.

Net Income (Loss) Per Share

Net income (loss) per common share, basic and diluted, is computed by dividing net income (loss) applicable to common shares by the weighted average number of common shares outstanding for the period. In periods of net loss, the assumed common share equivalents for options, warrants, and the Class A convertible preferred stock are anti-dilutive, and are therefore not included in the weighted average shares balance on the consolidated statement of operations. As of June 30, 2005, the Company has options outstanding to purchase approximately 9.5 million shares of common stock, of which 4.2 million are exercisable, and exercisable warrants to purchase shares up to an additional 23.7 million shares of common stock that can further dilute investors, if exercised.

Stock-Based Compensation

As allowed by Statement of Financial Accounting Standards No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure," ("SFAS No. 148"), the Company has chosen to continue to account for compensation cost associated with its employee stock option plan in accordance with the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees,” (“APB No. 25”) adopting the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation,” (“SFAS No. 123”). Under this method, no compensation expense is recorded if stock options are granted at an exercise price equal to or greater than the fair market value of the Company’s stock on the grant date. If the Company had adopted the fair value method of accounting for its stock awards, stock-based compensation would have been determined based on the fair value for all stock awards at the grant date using a Black-Scholes pricing model and the following weighted average assumptions:

	Three months ended June 30, 2005	2004
Expected volatility	61.0%	63.0%
Risk free interest rate	3.8%	2.8%
Dividend yield	0.0%	0.0%
Expected life (range in years)	4.0	4.0
Fair value per share at grant date	$0.94	$2.76

	Six months ended June 30, 2005	2004
Expected volatility	61.0%	63.0%
Risk free interest rate	3.7%	2.7%
Dividend yield	0.0%	0.0%
Expected life (range in years)	4.0	4.0
Fair value per share at grant date	$0.96	$3.23

The Company's pro forma net loss applicable to common shares, and pro forma net loss per common share, basic and diluted, if the Company had used the fair value method would have been as follows (dollars in thousands, except per share data):

	Three months ended June 30, 2005	2004
Net loss applicable to common shares, as reported	$(32,652)	$(43,820)
Add: Stock-based employee compensation expense included in net loss, as reported	45	97
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all stock awards	(1,776)	(2,227)
Pro forma net loss applicable to common shares	$(34,383)	$(45,950)
Net loss per common share, basic and diluted — as reported	$ (0.18)	$ (0.31)
Net loss per common share, basic and diluted — pro forma	$ (0.19)	$ (0.33)

	Six months ended June 30, 2005	2004
Net loss applicable to common shares, as reported	$(78,607)	$(92,314)
Add: Stock-based employee compensation expense included in net loss, as reported	111	226
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all stock awards	(3,422)	(4,101)
Pro forma net loss applicable to common shares	$(81,918)	$(96,189)
Net loss per common share, basic and diluted — as reported	$ (0.43)	$ (0.67)
Net loss per common share, basic and diluted — pro forma	$ (0.45)	$ (0.70)

The XO Communications, Inc. 2002 Stock Incentive Plan (the "2002 Stock Incentive Plan") was adopted in

January 2003 and amended and restated in July 2003. Under the 2002 Stock Incentive Plan, the Company is authorized to issue awards for up to 17.6 million shares of its common stock in the form of restricted stock or options to purchase stock. The Company granted a total of 195,000 options during the three months ended June 30, 2005. The Company granted a total of 342,500 options during the six months ended June 30, 2005.

Comprehensive Loss

Comprehensive loss includes the Company's net loss applicable to common shares, as well as net unrealized gains and losses on available-for-sale investments. The following table reflects the Company's calculation of comprehensive loss for the three and six months ended June 30, 2005 and 2004 (dollars in thousands):

	Three Months Ended June 30,	
	2005	2004
Net loss applicable to common shares	$(32,652)	$(43,820)
Other comprehensive loss:		
Net unrealized (losses) gains on investment	(1,220)	1,627
Comprehensive loss	$(33,872)	$(42,193)

	Six Months Ended June 30,	
	2005	2004
Net loss applicable to common shares	$(78,607)	$(92,314)
Other comprehensive loss:		
Net unrealized (losses) gains on investment	(2,780)	3,021
Reclassification adjustment for gain included in net income	(532)	—
Comprehensive loss	$(81,919)	$(89,293)

Long-Lived Assets

Long-lived assets include property and equipment, broadband wireless licenses, and intangible assets to be held and used. Long-lived assets, excluding intangible assets with indefinite useful lives, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," ("SFAS No. 144"). The criteria for determining impairment for such long-lived assets to be held and used is determined by comparing the carrying value of these long-lived assets to management's best estimate of future undiscounted cash flows expected to result from the use of the assets. The Company believes that no impairment existed under SFAS No. 144 as of June 30, 2005. In the event that there are changes in the planned use of the Company's long-lived assets or its expected future undiscounted cash flows are reduced significantly, the Company's assessment of its ability to recover the carrying value of these assets under SFAS No. 144 could change.

Intangible assets with indefinite useful lives are tested for impairment annually during the fourth quarter, or more frequently if an event indicates that the asset might be impaired, in accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS No. 142"). XO retained independent appraisers to perform a preliminary valuation of its assets and liabilities as of December 31, 2004. This valuation was necessary as XO's fair value, as determined by its stock price, was less than its book value. Based on this preliminary valuation, XO recorded a $212.5 million non-cash impairment charge on its goodwill during the year ended December 31, 2004. A full valuation was completed in the first quarter of 2005. There were no changes to the estimate of the impairment recorded in the fourth quarter of 2004.

Recent Accounting Pronouncements

Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"), was issued in December 2004. Once effective, this statement will require entities to recognize compensation cost for all equity-classified awards granted, modified or settled after the effective date using a fair-value measurement method. In addition, public companies will recognize compensation expense for the unvested portion of awards outstanding as of the effective date based on their grant-date fair value as calculated under the original provisions of SFAS No. 123. The effective date for XO is the fiscal year beginning January 1, 2006. The amount of compensation expense that XO records after the adoption of SFAS No. 123R in 2006 and beyond will depend on the amount, timing and pricing of stock option grants.

2. MARKETABLE SECURITIES AND OTHER INVESTMENTS

The amortized cost, gross unrealized gains and losses and fair value of the equity securities available-for-sale as of June 30, 2005 and December 31, 2004, are in the following table. Other investments as of June 30, 2005 and December 31, 2004 consist of investments in the debt of McLeodUSA, Inc. (dollars in thousands):

	Fair Value	Cost Basis	Gross Unrealized Holding Gains	Gross Unrealized Holding (Losses)
As of June 30, 2005				
Equity securities	$ 2,940	$ 1,540	$ 1,400	$ —
Other investments	6,515	6,515	—	—
Total marketable securities and other investments	$ 9,455	$ 8,055	$ 1,400	$ —
As of December 31, 2004				
Equity securities	$ 6,417	$ 1,705	$ 4,712	$ —
Other investments	10,883	10,883	—	—
Total marketable securities and other investments	$17,300	$12,588	$ 4,712	$ —

3. LONG-LIVED ASSETS

XO’s long-lived assets include property and equipment, broadband wireless licenses, and identifiable intangible assets to be held and used.

Property and Equipment

Property and equipment consisted of the following components (dollars in thousands):

	June 30, 2005	December 31, 2004
Telecommunications networks and acquired bandwidth	$ 711,296	$ 675,844
Furniture, fixtures, equipment, leasehold improvements and other	251,547	236,788
	962,843	912,632
Less: accumulated depreciation	(298,873)	(208,032)
	663,970	704,600
Construction-in-progress and undeployed assets	100,759	115,936
	$ 764,729	$ 820,536

Depreciation expense for the three and six months ended June 30, 2005 was $48.9 million and $95.2 million, respectively, and for the three and six months ended June 30, 2004 was $22.8 million and $42.0 million, respectively. Assets classified as construction-in-progress and undeployed assets are not being depreciated as they have not yet been placed in service. During the three and six months ended June 30, 2005, XO capitalized interest on construction costs of $0.8 million and $1.8 million, respectively and for the three and six months ended June 30, 2004 capitalized interest of $1.0 million and $1.9 million, respectively.

Broadband Wireless Licenses and Other Intangibles

Broadband wireless licenses and other intangible assets consisted of the following components (dollars in thousands):

	June 30, 2005	December 31, 2004
Broadband wireless licenses	$ 59,508	$ 59,508
Customer relationships	112,366	112,366
Internally developed technology	9,521	9,521
Acquired trade names	5,673	5,673
	187,068	187,068
Less: accumulated amortization	(88,163)	(63,864)
	98,905	123,204
XO Trade name — indefinite life asset	16,662	16,662
	$115,567	$139,866

Amortization expense related to intangible assets for each of the three and six months ended June 30, 2005 was $12.2 million and $24.3 million, respectively and for each of the three and six months ended June 30, 2004 was $7.2 million and $13.8 million, respectively.

4. LONG-TERM DEBT

The Company has a secured credit facility (the “Credit Facility”) which matures on July 15, 2009. There are no additional borrowings available under the Credit Facility. At June 30, 2005, more than 90% of the underlying loans of the Credit Facility are held by an entity controlled by Mr. Carl C. Icahn, Chairman of the Company’s Board of Directors (“Mr. Icahn”). At June 30, 2005, long-term debt consisted of $376.8 million in principal and $5.9 million of accrued interest that, if not paid, converts to principal. There are no current debt service requirements since cash interest payments as well as automatic and permanent quarterly reductions on the principal amount outstanding do not commence until 2009. However, in the event that consolidated excess cash flow (as defined in the Credit Facility) for any fiscal quarter during the term of the agreement is greater than $25.0 million, at the request of the lender, the Company will pay an amount equal to 50% of such excess cash flow greater than $25.0 million toward the reduction of outstanding indebtedness. In addition, if the ratio of XO’s consolidated earnings before interest, taxes, depreciation and amortization (“EBITDA”) to consolidated interest expense for four consecutive quarters exceeds 4:1, XO would be required to pay cash interest, unless waived by the lenders. The Company can elect to begin paying interest in cash prior to the required date. Loans under the Credit Facility bear interest, at the Company’s option, at an alternate base rate, as defined, or a Eurodollar rate plus, in each case, applicable margins. Once the Company begins to pay accrued interest in cash, the applicable margins are reduced. At June 30, 2005, the annualized weighted average interest rate applicable to outstanding borrowings under the Credit Facility was 8.9%.

The security for the Credit Facility consists of all assets of XO including the stock of its direct and indirect subsidiaries, and substantially all the assets of those subsidiaries. The Credit Facility limits additional indebtedness, liens, dividend payments and certain investments and transactions, and contains certain covenants with respect to EBITDA requirements, as the term EBITDA is defined in the Credit Facility, and maximum capital expenditures. The Company was required to achieve a minimum consolidated EBITDA of not less than $135.0 million for the twelve-month period ended June 30, 2005. The Company is also required under the terms of the Credit Facility to maintain an unrestricted cash balance of $25 million at the end of each fiscal quarter.

In May of 2005, XO obtained a waiver of compliance with the minimum consolidated EBITDA covenant (the “Waiver”) contained in the Credit Facility through December 31, 2006. The Waiver was obtained from the affiliate of Mr. Icahn which holds a majority of the Company’s loans outstanding under that agreement. In connection with the Waiver, XO agreed that in the event of a sale of the Company and in the event of other significant sale or divestiture transactions, it will prepay all amounts outstanding under the Credit Facility in cash and offer to repurchase outstanding shares of XO’s preferred stock at their liquidation value accrued through the date of redemption for cash or, in certain events, securities. The affiliate of Mr. Icahn which holds a majority of such Preferred Stock agreed to accept that offer, to the extent it consists of cash.

In the event that the Company is not in compliance with the minimum consolidated EBITDA covenant when the Waiver expires, there can be no guarantee that the Company will be able to obtain another waiver.

5. RELATED PARTY TRANSACTIONS

Various entities controlled by Mr. Icahn hold the following interests in XO:

	Outstanding Common Stock	Series A, B and C Warrants	Credit Facility	Preferred Stock
At December 31, 2004	Greater than 50%	Greater than 40%	Greater than 90%	95%
At June 30, 2005	Greater than 50%	Greater than 40%	Greater than 90%	95%

As a result of his majority ownership, Mr. Icahn can elect all of our directors, appoint the members of the committees of our Board of Directors, appoint key members of our executive management team, and appoint our auditors. Currently, Mr. Icahn is Chairman of the Board of Directors and three employees of Icahn Associates also sit on the Board of Directors and various Committees of the Board of Directors. Under applicable law and XO's Certificate of Incorporation and by-laws, certain actions cannot be taken without the approval of holders of a majority of our voting stock, including, without limitation, mergers, acquisitions, the sale of substantially all our assets, and amendments to our Certificate of Incorporation and by-laws.

Mr. Icahn, through various entities that he owns or controls, has the right to require XO to register, under the Securities Act of 1933, shares of XO's Common Stock held by such entities and to include shares of XO's Common Stock held by them in certain registration statements filed by XO.

The Company provides certain telecommunications services to companies affiliated with Mr. Icahn. The total revenue recognized on such services for the three months ended June 30, 2005 and 2004 was $1.2 million and $0.5 million, respectively. The total revenue recognized on such services for the six months ended June 30, 2005 and 2004 was $2.3 million and $0.7 million, respectively.

During the three months ended June 30, 2005 and 2004, the Company purchased approximately $0.3 million and $0.1 million, respectively, in services from Icahn affiliates. During the six months ended June 30, 2005 and 2004, the Company purchased approximately $0.6 million and $0.4 million, respectively, in services from Icahn affiliates.

During the three months ended June 30, 2005 and 2004, the Company purchased approximately $0.5 million and $0.1 million, respectively in hardware and services from Dell Computers, Inc. During the six months ended June 30, 2005 and 2004, the Company purchased approximately $0.6 million and $0.2 million, respectively, in hardware and services from Dell Computers, Inc. Mr. Adam Dell, an XO director, is the brother of Mr. Michael Dell, the Chairman of Dell Computers, Inc.

6. COMMITMENTS AND CONTINGENCIES

Legal Proceedings

XO is involved in lawsuits, claims, investigations and proceedings consisting of commercial, securities, tort, and employment matters, which arise in the ordinary course of business. In accordance with Statement of Financial Accounting Standards 5, "Accounting for Contingencies," XO makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. XO believes it has adequate provisions for any such matters. XO reviews these provisions at least quarterly and adjusts these provisions to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, XO believes that it has valid defenses with respect to legal matters pending against it. Nevertheless, it is possible that cash flows or results of operations could be materially and adversely affected in any particular period by the unfavorable resolution or disposition of one or more of these contingencies.

Allegiance Telecom Liquidating Trust Litigation

Subsequent to the Closing Date, the Unacquired Businesses as well as the ongoing Allegiance bankruptcy claims were transferred from Allegiance to the Allegiance Telecom Liquidating Trust (the "ATLT"). XO filed an administrative claim with the Bankruptcy Court in August 2004 against the ATLT, for at least approximately $40 million under the Purchase Agreement and other agreements between the parties, relating to a variety of actions allegedly taken by Allegiance and the ATLT. Subsequently, XO informed the ATLT that the amount in dispute approximates $50 million. The ATLT has asserted a counterclaim alleging that it is owed approximately $100 million in respect to operating, working capital and other disputes that have arisen between the parties. XO is vigorously trying its claim and believes that the ATLT's counterclaim is frivolous and without merit. As of June 30, 2005, XO had $8.0 million recorded in other assets, net related to certain payments made by XO on behalf of the Unacquired Businesses that XO believes is reimbursable by the ATLT. Other than this amount, the accompanying financial statements do not include any impact from the litigation. The case went to trial on May 2, 2005 and has not yet been decided.

Prior to the acquisition of the Acquired Businesses, XO purchased $92.5 million in face value of unsecured Allegiance debt securities (the "Claim"). Consequently, XO is a claimant in Allegiance's bankruptcy. It is difficult to assess how much of the Claim XO will recover, or when the recovery will be paid. This assessment could change based upon the total amount of claims the ATLT is directed to pay, the amount of administrative costs that it incurs, and the value of its assets, including 45.4 million shares of XO's common stock. The estimated fair value of the Claim of approximately $26.1 million is recorded in other assets in the Condensed Consolidated Balance Sheets as of June 30, 2005.

Telecom of Nevada Litigation

Start Investments Inc. (“Start”) is XOC’s 10% minority partner in Telecommunications of Nevada (“TON”), a Nevada joint venture company whose results of operations are consolidated into the accompanying financial statements. XOC and Start hold promissory notes (“the Notes”) from TON for $63.5 million (the “XOC Note”) and $7.1 million (the “Start Note”), respectively. The Notes became due in December 2002 and were not paid or extended on that date, but cannot be accelerated or foreclosed upon without the consent of XOC, which XOC has declined to give, acting in what it believes are the best interests of TON. TON has paid current interest on the Notes to both holders, but at the historic rate of interest, not the higher default rate. Start filed a suit against TON and XOC in October of 2003, which alleged that XOC had tortiously interfered with Start’s contractual relations with TON and breached it’s duty of good faith and fair dealing. The suit seeks temporary injunctive and declaratory relief, as well as damages of approximately $9.0 million, consisting primarily of the principal amount of the Start Note and interest at the default rate. In July 2005, Start moved to amend its complaint to add a claim against TON for breach of contract for failure to pay the Start Note. XOC believes it has valid defenses to the claims raised by Start and to its purported calculation of any damages. However, in the event that TON is required to pay the full principal amount of the Notes, absent a negotiated, out-of-court financial restructuring, TON may be forced to seek protection under chapter 11 of the Federal Bankruptcy Code, which could trigger a default on the Credit Facility of the Company.

The XOC Note and the accrued interest payable from TON to XOC, and the related note and interest receivable of XOC from TON, are inter-company balances and, in accordance with the principles of consolidation discussed in Note 1, have been eliminated in the consolidation of the financial statements. The Start Note and the related accrued interest payable, totaling approximately $8.3 million, are included in other current liabilities in the accompanying Condensed Consolidated Balance Sheet.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-looking and Cautionary Statements

Some statements and information contained in this document are not historical facts, but are "forward-looking statements," as such term is defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements can be identified by the use of forward-looking terminology such as "believes," "expects," "plans," "may," "will," "would," "could," "should," or "anticipates" or the negative of these words or other variations of these words or other comparable words, or by discussions of strategy that involve risks and uncertainties. Such forward-looking statements include, but are not limited to, statements regarding:

- our services, including the development and deployment of data products and services based on IP, Ethernet and other technologies and strategies to expand our targeted customer base and broaden our sales channels;
- the operation of our network and back office systems, including with respect to the development of IP protocols;
- liquidity and financial resources, including anticipated capital expenditures, funding of capital expenditures and anticipated levels of indebtedness;
- trends related to and expectations regarding the results of operations in future periods, including but not limited to those statements set forth in Management's Discussion and Analysis of Financial Condition and Results of Operations below; and
- the impact of judicial decisions, legislation, and regulatory developments on our cost structure, services, and marketing initiatives.

All such forward-looking statements are qualified by the inherent risks and uncertainties surrounding expectations generally and also may materially differ from our actual experience involving any one or more of these matters and subject areas. The operation and results of our business also may be subject to the effect of other risks and uncertainties in addition to the relevant qualifying factors identified in the "Liquidity Assessment" discussions set forth below and the "Risks and Uncertainties" discussion and the "Risk Factors" section of our 2004 Annual Report, including, but not limited to:

- general economic conditions in the geographic areas that we are targeting for the sale of telecommunications services;
- the ability to achieve and maintain market penetration and average per customer revenue levels sufficient to provide financial viability to our business;
- the quality and price of similar or comparable telecommunications services offered, or to be offered, by our current or future competitors; and
- future telecommunications-related legislation or regulatory developments and the conduct of incumbent carriers in reaction to such developments.

Management Overview

We provide a comprehensive array of telecommunications services to business customers. We provide our services, including local and long distance voice using both traditional delivery methods and Voice over Internet Protocol, or VoIP, Internet access, private data networking and hosting services, through our national telecommunications network, which consists of more than 9,000 route miles of fiber optic lines connecting 953 unique Incumbent Local Exchange Carrier, or ILEC, end-office collocations in 37 U.S. cities. In addition, we own licenses to deliver telecommunications services via local multipoint distribution service, or LMDS, wireless spectrum in 75 U.S. cities. We market our services primarily to business customers, ranging from small and medium businesses to Fortune 500 companies to carrier and wholesale customers. Our services offer an effective telecommunications solution for nearly any business, and our national telecommunications network is particularly advantageous to multi-location businesses that desire to improve telecommunications among their locations, whether within a single metropolitan area or across the country.

To serve our customers' broad telecommunications needs, we operate a network comprised of a series of rings of fiber optic cables located in the central business districts of numerous metropolitan areas, which we refer to as metro fiber networks, that are connected primarily by a network of numerous dedicated wavelengths of transmission capacity on fiber optic cables, which we refer to as an intercity network. By integrating these networks with advanced telecommunications technologies, we are able to provide a comprehensive array of telecommunications services primarily or entirely over a network that we own or control, from the initiation of the voice or data transmission to the point of termination, which we refer to as end-to-end service. This capability enables us to provide telecommunications services between customers connected to our network and among customers with multiple locations primarily or entirely over our network.

With the acquisition of Allegiance Telecom, Inc.'s, or Allegiance's, network assets and customer base, which we refer to as the Acquired Businesses, in June 2004, we became one of the nation's largest competitive providers of national local telecommunications and broadband services. We own one of the largest networks of nationwide connections to the Regional Bell Operating Companies', or RBOCs', networks, and doubled our Points of Presence (PoPs) within the 36 metropolitan areas where both XO and Allegiance operated. We believe that this extensive network will allow the combined company to (i) improve delivery of service to customers, (ii) improve operating results, and (iii) improve our ability to compete with other companies in the nationwide local telecommunications services market.

Management uses certain key performance indicators, or KPIs, to assess operational effectiveness of the business, including:

- Gross Margin
- Sales, Operating and General Expenses as a Percentage of Revenue
- EBITDA

The following table outlines the measurements of these KPIs as a percentage of revenue for the second quarter of 2005 and 2004:

	Three Months Ended June 30, 2005	2004
Gross margin	61.9%	57.3%
EBITDA	10.6%	(3.1%)
Sales, operating & general expenses	51.8%	59.0%

	Six Months Ended June 30, 2005	2004
Gross margin	60.5%	57.6%
EBITDA	8.3%	(4.9%)
Sales, operating & general expenses	52.4%	61.7%

Management believes that EBITDA and gross margin are measures of operating performance and liquidity that reflect the ongoing effectiveness of management's sales, cost reduction, and acquisition initiatives. Sales, operating and general expense is an important measure of the efficiency with which we sell, provision and support our services, and the efficiency of our back office operations. See the further discussion of EBITDA and gross margin in the Comparison of Financial Results section below.

As discussed further under the heading “Critical Accounting Policies and Estimates”, the company settled certain billing disputes with telecommunications service providers in the first and second quarter of 2005, which resulted in a reduction of cost of service of approximately $10.0 million and $10.5 million, respectively. Additionally, in the second quarter of 2005, we revised estimates related to liabilities assumed in relation to the Acquired Businesses. These revisions resulted in a reduction to cost of service of $3.9 million. These settlements and estimate revisions contributed significantly to the improvements in the gross margin and EBITDA KPIs discussed above.

Recent Events

In March 2005, we retained Jefferies & Company, Inc. (“Jefferies”) to present strategic alternatives based on, among other things, the competitive environment of the telecommunications industry, the current regulatory environment, and the recent and pending mergers and acquisitions in our industry. We have received the Jefferies report, which addressed potential operational improvements, disposition and financing possibilities, and in May 2005, we retained Jefferies to assist us in exploring our strategic alternatives.

On April 18, 2005, we launched the Company’s initial Voice over Internet Protocol, or VoIP, product, named XOptions Flex, in 45 major metropolitan markets which includes more than 1,000 cities nationwide. We later expanded the product offering to two additional markets. VoIP enables customers to utilize “dynamic bandwidth allocation” to maximize the utilization of their bandwidth by allocating it for data applications during periods when voice lines are idle. XOptions Flex bundles unlimited local and long distance calling, dedicated Internet access and web hosting services for a flat monthly price. In July of 2005, we signed the 1000th order of the XOptions Flex bundle package.

We have also begun to provide fixed broadband wireless backhaul services to mobile wireless telecommunications carriers using our LMDS spectrum. In April 2005, we reached an agreement to provide fixed broadband wireless services on a limited basis to one of the national mobile wireless carriers. We will continue to pursue opportunities to market and sell our fixed wireless solution to mobile wireless carriers both for primary network connectivity and redundancy and are exploring market opportunities to use this spectrum to provide local transport services to other major enterprise customers. We also plan to offer customers an LMDS-based wireless transport solution that would aggregate data traffic onto Ethernet and other higher speed wireless paths.

Results of Operations

The operational results of XO for the three and six months ended June 30, 2005 are discussed below. As the acquisition of the Acquired Businesses closed on June 23, 2004, or the Closing Date, our consolidated results of operations include the Acquired Businesses from the Closing Date through June 30, 2005. Forward looking information with respect to consolidated XO is discussed at the end of each financial results analysis. Our actual experience may differ materially from our projections of the combined company based on many factors including, among others:

- the inherent uncertainties in projecting future results for any business;
- the inability to predict the outcome of future judicial decisions, telecommunications related legislation or regulatory decisions, or the reaction by incumbent carriers to such developments.

Three and Six Months Ended June 30, 2005 versus the Three and Six Months Ended June 30, 2004

The following table contains certain data from our unaudited consolidated and condensed statement of operations presented in thousands of dollars and expressed as a percentage of total revenue. The information in this table should be read in conjunction with our consolidated and condensed financial statements, including the notes thereto, appearing elsewhere in this report (amounts in thousands, except for share and per share data):

	Three Months Ended June 30,			
	2005		2004	
Revenue	$ 362,164	100.0%	$ 278,183	100.0%
Costs and expenses:				
Cost of service (exclusive of depreciation and amortization)	138,024	38.1%	118,822	42.7%
Selling, operating and general	187,772	51.8%	164,149	59.0%
Depreciation and amortization	61,097	16.9%	30,065	10.8%
Total costs and expenses	386,893	106.8%	313,036	112.5%
Loss from operations	(24,729)	(6.8%)	(34,853)	(12.5%)
Interest income	1,919	0.5%	841	0.3%
Investment gain (loss)	1,891	0.5%	(3,962)	(1.4%)
Interest expense, net	(8,588)	(2.4%)	(5,846)	(2.1%)
Net loss	$ (29,507)	(8.1%)	$ (43,820)	(15.8%)
Preferred stock accretion	(3,145)	(0.9%)	—	—%
Net loss applicable to common shares	$ (32,652)	(9.0%)	$ (43,820)	(15.8%)
Net loss per common share, basic and diluted	(0.18)		(0.31)	
Weighted average shares outstanding, basic and diluted	181,933,035		140,538,159	
Gross margin (1)	224,140	61.9%	159,361	57.3%
EBITDA (2)	38,259	10.6%	(8,750)	(3.1%)

	Six Months Ended June 30,			
	2005		2004	
Revenue	$ 723,669	100.0%	$ 539,128	100.0%
Costs and expenses:				
Cost of service (exclusive of depreciation and amortization)	285,947	39.5%	228,783	42.4%
Selling, operating and general	379,466	52.4%	332,702	61.7%
Depreciation and amortization	119,461	16.5%	55,762	10.3%
Total costs and expenses	784,874	108.5%	617,247	114.5%
Loss from operations	(61,205)	(8.5%)	(78,119)	(14.5%)
Interest income	3,820	0.5%	2,546	0.5%
Investment gain (loss)	1,612	0.2%	(4,291)	(0.8%)
Interest expense, net	(16,592)	(2.3%)	(12,450)	(2.3%)
Net loss	$ (72,365)	(10.0%)	$ (92,314)	(17.1%)
Preferred stock accretion	(6,242)	(0.9%)	—	—%
Net loss applicable to common shares	$ (78,607)	(10.9%)	$ (92,314)	(17.1%)
Net loss per common share, basic and diluted	(0.43)		(0.67)	
Weighted average shares outstanding, basic and diluted	181,933,035		137,591,467	
Gross margin (1)	437,722	60.5%	310,345	57.6%
EBITDA (2)	59,868	8.3%	(26,648)	(4.9%)

(1) Gross margin is defined as revenue less cost of service, and excludes depreciation and amortization. Gross margin is not intended to replace operating income (loss), net income (loss), cash flow and other measures of financial performance reported in accordance with generally accepted accounting principles in the United States. Rather, gross margin is an important measure used by management to assess operating performance of the Company. Additionally, we believe that gross margin is a standard measure of operating performance that is commonly reported and widely used by analysts, investors, and other interested parties in the telecommunications industry. Gross margin as used in this document may not be comparable to similarly titled measures reported by other companies due to differences in accounting policies. A reconciliation between gross margin and net loss is as follows:

	Three Months Ended June 30, 2005	2004
Net loss	$ (29,507)	$ (43,820)
Selling, operating and general	187,772	164,149
Interest income	(1,919)	(841)
Investment (gain) loss, net	(1,891)	3,962
Interest expense, net	8,588	5,846
Depreciation and amortization	61,097	30,065
Gross margin	$ 224,140	$ 159,361

	Six Months Ended June 30, 2005	2004
Net loss	$ (72,365)	$ (92,314)
Selling, operating and general	379,466	332,702
Interest income	(3,820)	(2,546)
Investment (gain) loss, net	(1,612)	4,291
Interest expense, net	16,592	12,450
Depreciation and amortization	119,461	55,762
Gross margin	$ 437,722	$ 310,345

(2) EBITDA is defined as net income or loss before depreciation, amortization, interest expense, and interest income. EBITDA is not intended to replace operating income (loss), net income (loss), cash flow and other measures of financial performance reported in accordance with generally accepted accounting principles in the United States. Rather, EBITDA is an important measure used by management to assess operating performance of the company. EBITDA as used in this document may not be comparable to similarly titled measures reported by other companies due to differences in accounting policies. Additionally, EBITDA as defined here does not have the same meaning as EBITDA as defined in our secured credit facility agreement. A reconciliation between EBITDA and net loss is as follows:

	Three Months Ended June 30, 2005	2004
Net loss	$(29,507)	$(43,820)
Interest income	(1,919)	(841)
Interest expense, net	8,588	5,846
Depreciation and amortization	61,097	30,065
EBITDA	$ 38,259	$ (8,750)

	Six Months Ended June 30, 2005	2004
Net loss	$ (72,365)	$(92,314)
Interest income	(3,820)	(2,546)
Interest expense, net	16,592	12,450
Depreciation and amortization	119,461	55,762
EBITDA	$ 59,868	$(26,648)

Revenue. Total revenue for the three months ended June 30, 2005 increased 30.2% to $362.2 million from $278.2 million for the same period in 2004. Revenue for the six months ended June 30, 2005 increased 34.2% to $723.7 million from $539.1 million for the same period in 2004. Substantially all of the increase is attributable to the inclusion of the Acquired Businesses in the results for the three and six months ended June 30, 2005.

We believe that revenue for the remainder of 2005 will remain flat relative to the second quarter of 2005 results.

Revenue was earned from providing the following services (dollars in thousands):

	Three months ended June 30,				
	2005	% of Revenue	2004	% of Revenue	% Change
Voice services	$188,498	52.0%	$141,679	50.9%	33.0%
Data services	107,779	29.8%	95,612	34.4%	12.7%
Integrated voice and data services	65,887	18.2%	40,892	14.7%	61.1%
Total revenue	$362,164	100.0%	$278,183	100.0%	30.2%

	Six months ended June 30,				
	2005	% of Revenue	2004	% of Revenue	% Change
Voice services	$374,797	51.8%	$272,600	50.5%	37.5%
Data services	216,171	29.9%	188,561	35.0%	14.6%
Integrated voice and data services	132,701	18.3%	77,967	14.5%	70.2%
Total revenue	$723,669	100.0%	$539,128	100.0%	34.2%

Voice services revenue includes revenue from local and long distance voice services, prepaid calling card processing, interactive voice response services, stand-alone long distance services and other voice telecommunications based services. For the three and six months ended June 30, 2005, revenue from voice services increased $46.8 million or 33.0% and $102.2 million or 37.5% as compared to the same periods in 2004. Substantially all of the increase is attributable to the inclusion of the Acquired Businesses in the results for the three and six months ended June 30, 2005.

Data services revenue includes revenue from Internet access, network access and web hosting services. For the three and six months ended June 30, 2005, revenue from data services increased $12.2 million or 12.7% and $27.6 million or 14.6% as compared to the same periods in 2004. Substantially all of the increase is attributable to the inclusion of the Acquired Businesses in the results for the three and six months ended June 30, 2005.

Integrated voice and data services revenue includes revenue from our XOptions, XOptions Flex and Total Communications service offerings, XO's flat-rate bundled packages offering a combination of voice and data services and integrated access. For the three and six months ended June 30, 2005, revenue from integrated voice and data services increased $25.0 million or 61.1% and $54.7 million or 70.2% as compared to the same periods in 2004. Substantially all of the increase is attributable to the inclusion of the Acquired Businesses in the results for the three months ended June 30, 2005.

Costs and expenses. The table below provides costs and expenses by classification and as a percentage of revenue (dollars in thousands).

	Three months ended June 30,		Three months ended June 30,		
	2005	% of Revenue	2004	% of Revenue	% Change
Costs and expenses:					
Cost of service (excluding depreciation and amortization)	$138,024	38.1%	$118,822	42.7%	16.2%
Selling, operating and general	187,772	51.8%	164,149	59.0%	14.4%
Depreciation and amortization	61,097	16.9%	30,065	10.8%	103.2%
Total	$386,893		$313,036		23.6%

	Six months ended June 30,		Six months ended June 30,		
	2005	% of Revenue	2004	% of Revenue	% Change
Costs and expenses:					
Cost of service (excluding depreciation and amortization)	$285,947	39.5%	$228,783	42.4%	25.0%
Selling, operating and general	379,466	52.4%	332,702	61.7%	14.1%
Depreciation and amortization	119,461	16.5%	55,762	10.3%	114.2%
Total	$784,874		$617,247		27.2%

Cost of service (exclusive of depreciation and amortization). Cost of service includes expenses directly associated with providing telecommunications services to our customers. Cost of service includes, among other items, the cost of connecting customers to our network via leased facilities, the costs of leasing components of our network facilities and costs paid to third party service providers for interconnect access and transport services. Cost of service as a percentage of revenue for the three and six months ended June 30, 2005 decreased as compared to the same periods in 2004, primarily due to $20.5 million in settlements with two telecommunications service providers, $10.5 million of which was recorded during the three months ended June 30, 2005 and $10.0 million of which was recorded during the three months ended March 31, 2005. Additionally, in the second quarter of 2005, we revised estimates related to liabilities assumed in relation to the Acquired Businesses. These revisions resulted in a reduction to cost of service of $3.9 million. We originally estimated a potential benefit of approximately $60.0 million in pro forma annualized network synergies for the combined companies if our integration efforts with the Acquired Businesses were successful. We have made substantial progress integrating the two companies and are on plan to reach our synergy targets.

We believe that, excluding the settlements and estimate revisions referenced above, cost of service as a percentage of revenue for the remainder of 2005 will remain stable to slightly down relative to the second quarter of 2005 results. Cost of service will be adversely impacted due to the recently enacted regulatory rules on unbundled network element, or UNE, loop and transport rates as discussed in the "Regulatory Overview" section below. The UNE and transport rate increases will be phased in during 2005 and the first quarter of 2006. We expect these increases to have a total annualized impact, including transitional and special access rates, of approximately $85 million by the end of the first quarter of 2006. However, we believe that actions we are taking, including negotiating rate reductions, network optimization, and price increases to our customers, will offset these increases.

Selling, operating and general. Selling, operating and general expense includes expenses related to network maintenance, sales and marketing, network operations and engineering, information systems, general corporate office functions and collection risks. Selling, operating and general expense for the three months ended June 30, 2005 was $187.8 million or 51.8% of revenue compared to $164.1 million or 59.0% of revenue for the three months ended June 30, 2004. Selling, operating and general expense for the six months ended June 30, 2005 was $379.5 million or 52.4% of revenue compared to $332.7 million or 61.7% of revenue for the six months ended June 30, 2004. The improvements as a percentage of revenue are largely attributable to the synergies obtained through the integration of the Acquired Businesses. We originally estimated a potential benefit of approximately $100.0 million in pro forma annualized selling, operating and general expense synergies for the combined companies if our integration efforts with the Acquired Businesses were successful. We have completely integrated the administrative functions and have exceeded the estimated annualized synergies.

As discussed further in the section entitled Critical Accounting Policies and Estimates below, selling, operating and general expenses for the three and six months ended June 30, 2005 includes an adjustment of approximately $8.3 million relating to our accounting for leases.

We believe that selling, operating and general expense will remain stable or decrease slightly as a percentage of revenue during the remainder of 2005 as compared to the second quarter of 2005 results.

Depreciation and amortization. Depreciation expense was $48.9 million for the three months ended June 30, 2005, compared to $22.8 million for the same period in 2004 and $95.2 million for the six months ended June 30, 2005, compared to $42.0 million for the same period in 2004. Total amortization expense was $12.2 million for the second quarter of 2005 and $7.2 million for the second quarter of 2004 and was $24.3 million in the first half of 2005 and $13.7 million in the first half of 2004. Substantially all of the increases in depreciation and amortization are attributable to the acquisition of the Acquired Businesses.

As of June 30, 2005, we had approximately $100.8 million of fixed assets and $23.5 million of broadband wireless licenses that have not yet been placed into service and, accordingly, are not currently being depreciated or amortized. We expect depreciation and amortization expense to increase as a percentage of revenue for the remainder of 2005 as we place more fixed wireless licenses into service.

Interest income. Interest income for the three months ended June 30, 2005 increased to $1.9 million from $0.8 million for the three months ended June 30, 2004. Interest income for the six months ended June 30, 2005 increased to $3.8 million from $2.5 million in the six months ended June 30, 2004. The increase in interest income is due to an increase in the amount of cash and cash equivalents invested and an increase in interest rates.

Investment gain (loss), net. Investment gain (loss), net includes any realized gains or losses from the sale or other than temporary impairment of investments. For the three months ended June 30, 2005 we reported a net investment gain of $1.9 million while we reported net investment loss of $4.0 million for the same period of 2004. Investment gain, net for the six months ended June 30, 2005 was $1.6 million while we had net investment loss of $4.3 million for the same period in 2004. The improvement is largely attributable to a realized loss on the sale of an investment during the second quarter of 2004.

Interest expense, net. Interest expense, net includes interest expense on debt and capital leases, less any amounts capitalized. The majority of interest expense in the three and six months ended June 30, 2005 and 2004 is non-cash as our secured credit facility allows for accrued interest to be converted into principal if unpaid. Interest expense, net for the three months ended June 30, 2005 and 2004 was $8.6 million and $5.8 million, respectively. Interest expense, net for the six months ended June 30, 2005 and 2004 was $16.6 million and $12.5 million, respectively. The increase in interest expense is due to an increase in interest rates, as well as the compounding effect of the conversion of accrued interest to principal.

Net Loss. Net loss decreased $14.3 million to a loss of $29.5 million for the three months ended June 30, 2005, from a net loss of $43.8 million for the comparable period in 2004. Net loss decreased $19.9 million to a loss of $72.4 million for the six months ended June 30, 2005, from a net loss of $92.3 million for the comparable period in 2004. The decrease primarily resulted from the achievement of synergies resulting from the integration of the Acquired Businesses, offset by additional depreciation and amortization from the inclusion of the property and equipment and intangibles of the Acquired Businesses. Additionally, we recognized approximately $24.4 million of reductions in cost of service expenses for the six months ended June 30, 2005 from the settlements and estimate revisions discussed above.

EBITDA. EBITDA increased to $38.3 million for the three months ended June 30, 2005 from $(8.7) million for the comparable period in 2004 and increased to $59.9 million for the six months ended June 30, 2005 from $(26.6) million for the comparable period in 2004. The increase primarily resulted from the achievement of synergies resulting from the integration of the Acquired Businesses and the settlements and estimate revisions discussed above.

Critical Accounting Policies and Estimates

Our significant accounting policies are more fully described in the notes to the consolidated financial statements in our 2004 Annual Report. The preparation of the condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States requires management to make judgments, estimates and assumptions regarding uncertainties that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Management uses historical experience and all available information to make these judgments and estimates and actual results could differ from those estimates and assumptions that are used to prepare our financial statements at any given time. Despite these inherent limitations, management believes that Management's Discussion and Analysis and the accompanying condensed consolidated financial statements and footnotes provide a meaningful and fair perspective of our financial condition and our operating results for the current period. Management's Discussion and Analysis and Note 3 to the Consolidated Financial Statements in the XO Communications, Inc. Annual Report on Form 10-K for the year ended December 31, 2004 describe the significant estimates and accounting policies used in preparation of the Condensed Consolidated Financial Statements.

During the six months ended June 30, 2005, we resolved certain billing disputes with telecommunications service providers (the "Carriers"). In accordance with our policy for disputed charges, all amounts billed by the Carriers had previously been recorded as a cost of service in our Condensed Consolidated Statement of Operations. Because these disputes were resolved favorably to us, they resulted in a reduction of cost of service of approximately $10.0 million and $10.5 million during the first and second quarters of 2005, respectively.

In the second quarter of 2005, in conjunction with a review of certain accounting policies, we determined that we were not applying the proper generally accepted accounting principles to lease escalation provisions contained in certain of our operating leases since our emergence from bankruptcy in January 2003. Additionally, we determined that certain assets had been depreciating over lives inconsistent with our depreciation policy, and that certain leasehold improvements had not been expensed when the related lease contract had been terminated prior to the end of the initial lease term. Accordingly, an adjustment of $8.3 million was recorded to increase selling, operating and general expenses and other current liabilities, and an adjustment of $2.5 million was recorded to increase depreciation expense and to reduce Property and Equipment, net during the three months ended June 30, 2005. The impact of these adjustments would have increased selling operating and general expense by approximately $4.5 million, $3.3 million, and $0.5 million for the years ended December 31, 2003, December 31, 2004 and the three months ended March 31, 2005, respectively, and would have increased depreciation expense by approximately $0.5 million, $1.0 million, and $1.0 million for the years ended December 31, 2003, December 31, 2004 and the three months ended March 31, 2005, respectively, had they been recorded in the appropriate periods. We have concluded that the adjustment is immaterial to the financial statements on both a quantitative and qualitative basis for all periods affected. Accordingly, the adjustment has been made in the current period financial statements. The adjustment does not affect our historical or future cash flows or the timing of payments under the relevant leases.

Liquidity and Capital Resources

Capital Resources and Liquidity Assessment

During the three months ended June 30, 2005, our operating activities provided net cash of $32.2 million, our investing activities used net cash of $18.0 million and our financing activities used net cash of $0.7 million. For the six months ended June 30, 2005, our operating activities provided net cash of $50.4 million, our investing activities used net cash of $12.8 million, and our financing activities used net cash of $1.5 million. Our balance of cash and cash equivalents increased to $270.1 million at June 30, 2005 from $234.0 million at December 31, 2004.

Our cash flows from operating activities for the six months ended June 30, 2005 were aided by a cash settlement of approximately $10.0 million with a telecommunications service provider during the first quarter of 2005. Cash used in investing activities for the six months ended June 30, 2005 was aided by the release, during the first quarter of 2005, of approximately $25.4 million that had previously held in escrow and classified as other current assets in the Condensed Consolidated Balance Sheet.

We project that we will have sustainable positive cash flows by the end of 2005. Our projection is based upon, among other things, our estimated increased costs of service attributable to the recent Triennial Review Remand Order, or TRRO, discussed in the “Regulatory Overview” below, and other projected operating costs that are not entirely under our control. As a result, our projections may be incorrect if our estimates of such costs and expenses are inaccurate.

We have a secured credit facility, or the Credit Facility, which matures on July 15, 2009. There are no additional borrowings available under the Credit Facility. At June 30, 2005, more than 90% of the underlying loans of the Credit Facility are held by an entity controlled by Mr. Carl C. Icahn, Chairman of the Company’s Board of Directors (“Mr. Icahn”). At June 30, 2005, long-term debt consisted of $376.8 million in principal and $5.9 million of accrued interest that, if not paid, converts to principal. There are no current debt service requirements since cash interest payments as well as automatic and permanent quarterly reductions on the principal amount outstanding do not commence until 2009. However, in the event that consolidated excess cash flow (as defined in the Credit Facility) for any fiscal quarter during the term of the agreement is greater than $25.0 million, at the request of the lender, we will pay an amount equal to 50% of such excess cash flow greater than $25.0 million toward the reduction of outstanding indebtedness. In addition, if the ratio of XO’s consolidated earnings before interest, taxes, depreciation and amortization (“EBITDA”), as defined in the Credit Facility, to consolidated interest expense for four consecutive quarters exceeds 4:1, we would be required to pay cash interest, unless waived by the lenders. We can elect to begin paying interest in cash prior to the required date. Loans under the Credit Facility bear interest, at our option, at an alternate base rate, as defined, or a Eurodollar rate plus, in each case, applicable margins. Once we begins to pay accrued interest in cash, the applicable margins are reduced. At June 30, 2005, the annualized weighted average interest rate applicable to outstanding borrowings under the Credit Facility was 8.9%.

The security for the Credit Facility consists of all of our assets including the stock of our direct and indirect subsidiaries, and substantially all the assets of those subsidiaries. The Credit Facility limits additional indebtedness, liens, dividend payments and certain investments and transactions, and contains certain covenants with respect to EBITDA requirements, as the term EBITDA is defined in the Credit Facility, and maximum capital expenditures. The definition of EBITDA in the Credit Facility differs from the definition of EBITDA discussed in “Results of Operations” above. We were required to achieve a minimum consolidated EBITDA of not less than $135.0 million for the twelve-month period ended June 30, 2005. We are also required under the terms of the Credit Facility to maintain an unrestricted cash balance of $25.0 million at the end of each fiscal quarter.

In May of 2005, we obtained a waiver of compliance with the minimum consolidated EBITDA covenant contained in the Credit Facility through December 31, 2006. The waiver was obtained from the affiliate of Mr. Icahn which holds a majority of our loans outstanding under that agreement. In connection with that waiver, we agreed that in the event of a sale of the Company and in the event of other significant sale or divestiture transactions, we will prepay all amounts outstanding under the Credit Facility in cash and offer to repurchase outstanding shares of our preferred stock at their liquidation value accrued through the date of redemption for cash or, in certain events, securities. The affiliate of Mr. Icahn which holds a majority of such Preferred Stock has agreed to accept that offer, to the extent it consists of cash.

In the event that we are not in compliance with the minimum consolidated EBITDA covenant when the waiver expires, there can be no guarantee that we will be able to obtain another waiver.

Credit Risk

Financial instruments that potentially subject us to concentrations of credit risk consist primarily of trade receivables. Although our trade receivables are geographically dispersed and include customers in many different industries, a portion of our revenue is generated from services provided to other telecommunications service providers. We believe that our established valuation and credit allowances are adequate as of June 30, 2005 to cover these risks.

Regulatory Overview

Overview

We are subject to regulation by federal, state and local government agencies. Historically, the Federal Communications Commission, or FCC, had jurisdiction over interstate long distance services and international services, while state regulatory commissions had jurisdiction over local and intrastate long distance services. The

Telecommunications Act of 1996, or the Telecom Act, fundamentally changed the way telecommunications is regulated in this country. The FCC was given a major role in writing and enforcing the rules under which new competitors could compete in the local marketplace. Those rules, coupled with additional rules and decisions promulgated by the various state regulatory commissions, form the core of the regulatory framework under which we operate in providing our services.

With a few limited exceptions, the FCC continues to retain exclusive jurisdiction over our provision of interstate and international long distance services, and the state regulatory commissions regulate our provision of intrastate local and long distance services. Additionally, municipalities and other local government agencies may regulate limited aspects of our business, such as use of government-owned rights-of-way, and may require permits such as zoning approvals and building permits.

The Telecom Act and the related rules governing competition issued by the FCC, as well as pro-competitive policies already developed by state regulatory commissions, have enabled new entrants like us to capture a portion of the ILECs' market share of local services. However, there have been numerous attempts to limit the pro-competitive policies in the local exchange services market through a combination of proposed federal legislation, adoption of new rules by the FCC, and ILEC challenges to existing and proposed regulations. To date, the ILECs have succeeded in eliminating some of the market-opening regulations adopted by the FCC and the states through numerous court challenges. In particular, the ILECs appealed, and won partial reversals of, a series of FCC orders defining the ILEC facilities, known as UNEs, that ILECs must lease to competitors at cost-based rates. We expect the ILEC's efforts to scale back the benefits of the Telecom Act and local service competition to continue. However, while the FCC has eliminated certain UNEs, the basic framework of local competition for facilities-based competitors such as us, has remained intact. The successful implementation of our business plan is predicated on the assumption that the basic competitive framework and pro-competitive safeguards will remain in place.

The passage of the Telecom Act largely preceded the explosive growth of the Internet and Internet Protocol, or "IP", communications. Congress is currently considering whether to further amend the Telecom Act to, among other things, directly address IP communications. It is possible that any such amendment to the Telecom Act could eliminate or materially alter the market-opening regulatory framework of the Telecom Act in general, and the UNE regime in particular. Such a result could adversely affect XO's business. It is not possible to predict if, when, or how the Telecom Act will be amended.

Federal Regulation

The FCC exercises jurisdiction over our telecommunications facilities and services. We have authority from the FCC for the installation, acquisition and operation of our wireline network facilities to provide facilities-based domestic interstate and international services. In addition, we have obtained FCC authorizations for the operation of our LMDS and 39 GHz broadband wireless facilities. Because we are not dominant in any of our markets, unlike ILECs, we are not subject to price cap or rate of return regulation. Thus, our pricing policies for interstate and international end user services are only subject to the federal guidelines that charges for such services be just, reasonable, and non-discriminatory. The FCC allows us to file interstate tariffs for our interstate access services (rates charged by us to other carriers for access to our network). As for domestic interstate and international long distance services, the FCC requires us to make the terms, conditions and rates of the detariffed services available to the public on XO's web page, and such terms, conditions, and rates are located at http://www.xo.com/legal/.

Implementation of the Telecom Act

The Telecom Act's Local Competition Framework

One of the key goals of the Telecom Act is to encourage competition in the provision of local telephone service. To do this, the Telecom Act provides three means by which competitive local exchange carriers, or CLECs, such as XO can enter the local telephone service market. The three modes of entry are as follows:

- ***Access to UNEs.*** ILECs are required to lease to CLECs various elements in their network that are used individually or in combination with each other to provide local telephone service. As discussed in more detail below, the FCC determines which facilities must be made available by the ILECs as UNEs. The ILECs must make UNEs available at rates that are based on their forward-looking economic costs, a pricing regime known as "TELRIC," short for Total Element Long Run Incremental Cost. For XO, the most critical UNEs are local loops and transport, which enable us to connect our customers to our network.

- ***Construction of New Facilities.*** CLECs may also enter the local service market by building entirely new facilities. The ILECs are required to allow CLECs to interconnect their facilities with the ILECs' facilities in order to reach all customers.

- ***Resale.*** ILECs are required to permit CLECs to purchase their services for resale to the public at a wholesale rate that is less than the rate charged by the ILECs to their retail customers.

To facilitate competitors' entry into local telephone markets using one or more of these three methods, the Telecom Act imposes on the ILECs the obligation to open their networks and markets to competition. When requested by competitors, ILECs are required to negotiate, in good faith, agreements that set forth terms governing the interconnection of their network, access to UNEs, and resale. We have negotiated interconnection agreements with the ILECs in each of the markets in which we operate. Many of these interconnection agreements are currently being renegotiated.

The following is a summary of the interconnection and other rights granted by the Telecom Act that are important for effective local service competition and our belief as to the effect of those requirements, if properly implemented:

- interconnection with the networks of incumbents and other carriers, which permits our customers to exchange traffic with customers connected to other networks;

- requirements that the ILECs make available access to their facilities for our local loops and transport needs, thereby enabling us to serve customers not directly connected to our networks;

- compensation obligations, which mandate reciprocal payment arrangements for local traffic exchange between us and both incumbent and other competitive carriers and compensation for terminating local traffic originating on other carriers' networks;

- requirements concerning local number portability, which allows customers to change local carriers without changing telephone numbers, thereby removing a significant barrier for a potential customer to switch to our local voice services;

- access to assignment of telephone numbers, which enables us to provide telephone numbers to new customers on the same basis as incumbent carriers; and

- collocation rights allowing us to place telecommunications equipment in ILEC central offices, which enables us to have direct access to local loops and other network elements.

Although the rights established in the Telecom Act are a necessary prerequisite to the introduction of full local competition, they must be properly implemented and enforced to permit competitive telephone companies like XO to compete effectively with the incumbent carriers. Discussed below are several FCC and court proceedings relating to the application of certain FCC rules and policies that are significant to and directly impact our operations and costs as well as the nature and scope of industry competition.

Unbundling of Incumbent Network Elements

In a series of orders and related court challenges that date back to 1996, the FCC has promulgated rules implementing the market-opening provisions of the Telecom Act, including the requirement that the ILECs lease UNEs to competitors at cost-based rates. At the core of the series of FCC orders is the FCC's evolving effort to define which ILEC network facilities must be made available as UNEs. Initially, the FCC defined a broad list of UNEs, consisting of most of the elements of the ILECs' networks. Under pressure from the ILECs, the FCC has subsequently reduced the list, while preserving access to those network elements critical to the operation of XO's business.

The current list of UNEs was promulgated by the FCC in two orders. The first is the Triennial Review Order, or TRO, which was released on August 21, 2003. Several carriers and other entities appealed the FCC's TRO decision. On March 2, 2004, the U.S. Court of Appeals for the D.C. Circuit issued its opinion in United States Telecom Association v. FCC, No. 00-1012 ("USTA II Decision"). In the USTA II Decision, the court reversed and overturned many of the conclusions of the TRO. In the aftermath of the USTA II Decision, the FCC released the second of its two currently controlling orders, the TRRO, on February 4, 2005. Various parties, including XO, have appealed the TRRO. The case is currently pending before the United States Court of Appeals for the D.C. Circuit. It is not possible to predict the outcome of those appeals. It is possible that portions of the TRRO could be overturned and that the FCC will issue new rules in their place that further restrict access to UNEs. In addition to the court challenges, several parties, including XO, have petitioned the FCC to reconsider various aspects of the TRRO. It is not possible to predict when or how the FCC will rule with respect to those reconsideration petitions.

As of March 11, 2005, the effective date of the TRRO, the ILECs are obligated to provide as UNEs the following network facilities used by XO to serve its customers:

UNE Loops

DS0 loops. A DS0 loop is a single, voice-grade channel. Typically, individual business lines are DS0 loops. The ILECs must make DS0 loops available at UNE rates on an unlimited basis.

DS1 loops. A DS1 loop is a digital loop with a total speed of 1.544 megabytes per second, which is the equivalent of 24 DS0 circuits. Multiple voice lines and Internet access can be provided to a customer over a single DS1 loop. We provide most of our service with DS1 loops. The ILECs must provide DS1 loops at UNE rates at the majority of their central offices. Competitors, however, are limited to no more than 10 DS1 loops to any particular building.

DS3 loops. A DS3 loop is a digital loop with a total speed of 44.736 megabytes per second, which is the equivalent of 28 DS1 circuits. In some cases, XO serves its large business customers with DS3 loops. ILECs must provide DS3 loops at UNE rates at the majority of their central offices. Competitors, however, are limited to no more than one DS3 loop to any particular building.

ILECs are not required to provide optical capacity loops or dark fiber loops as UNEs. Optical capacity loops, referred to as OCn loops, are very high-capacity digital loops ranging in capacity from OC3 loops, which are the equivalent of three DS3s to OC192. This will not impact our costs.

The ILECs are also not required to provide certain mass market broadband loop facilities and functionality as UNEs. Under the TRO, the ILECs are not required to make newly-deployed fiber-to-the-home, or FTTH, loops available as UNEs and are only required to provide the equivalent of DS0 capacity on any FTTH loop built over an existing copper loop. These recent FCC orders should only limit availability for those specific network elements, which are not material to us. It is possible, however, that the ILECs will seek additional broadband regulatory relief in future proceedings.

UNE Transport

DS1 transport. Whether transport is available as a UNE is determined on a route-by-route basis. ILECs must make transport at UNE rates available at DS1 capacity levels between any two ILEC central offices unless both central offices either (1) serve more than 38,000 business lines or (2) have four or more fiber-based collocators. On routes where DS1 transport must be made available, each individual competitor is limited to no more than 10 DS1 transport circuits per route.

DS3 transport. Access to DS3 capacity-level transport is more limited than access to DS1 transport. ILECs must make transport at UNE rates available at DS3 capacity levels between any two ILEC central offices unless both central offices either (1) serve more than 24,000 business lines or (2) have three or more fiber-based collocators. On routes where DS3 transport must be made available, each individual competitor is limited to no more than 12 DS1 transport circuits per route.

Dark fiber transport. Dark fiber transport is available under the same conditions as DS3 transport.

ILECs are not required to provide access to transport at greater-than DS3 capacity levels. ILECs are also not required to provide dark fiber transport at any capacity level to connect an ILEC central office with a competitor's facilities.

Transitional availability where elements are no longer available as UNEs

For DS1, DS3, and dark fiber loops and transport that do not meet the criteria for availability set forth above, the FCC established a transitional period during which the ILECs must continue to make the elements available at UNE rates to serve existing customers. For DS1 and DS3 loops and transport, the ILECs must make the elements available at 115% of the TELRIC rate for one year beginning on March 11, 2005. For dark fiber loops and transport, the ILECs must make the elements available at 115% of the TELRIC rate for 18 months beginning on March 11, 2005.

Although these rules adopted by the FCC in the TRRO became effective on March 11, 2005, many of the requirements imposed by the FCC in the TRO and TRRO were not self-executing. Accordingly, the FCC made clear that carriers must follow the change of law procedures in their applicable interconnection agreements with ILECs to implement any TRO requirements that are not self-executing and that carriers must follow the procedures set forth in Section 252(b) of the Telecom Act to modify interconnection agreements that are silent as to implementation of changes in law. We have been in negotiations with ILECs to amend our interconnection agreements to implement relevant TRO requirements and, to date, have executed amendments in several states.

Additional Federal Regulations

The following discussion summarizes some additional specific areas of federal regulation that directly affect our business.

VoIP. Like a growing number of carriers, we utilize IP technology for the transmission of a portion of our network traffic. The regulatory status and treatment of IP-enabled services is unresolved. The FCC has held that Vonage's VoIP services and similar offerings by other providers are subject to the FCC's interstate jurisdiction, preempting state efforts to regulate VoIP providers as intrastate telecommunications providers. Four separate state commissions have appealed this ruling and the case is currently pending. The FCC, however, left open the question of whether VoIP providers provide "telecommunications" — i.e., basic transmission services — or enhanced "information services." Under the Communications Act of 1934, as amended, or the Communications Act, those are mutually exclusive categories. Generally, telecommunications carriers, including traditional local and long distance telecommunications companies, are regulated under the Communications Act; information service providers are generally unregulated. The FCC has initiated a rulemaking proceeding to address the classification of VoIP and other IP-enabled service offerings. It is not possible to predict the outcome of that proceeding or its effect on XO's operations.

AT&T Declaratory Ruling Re: VoIP. On April 21, 2004, the FCC released an order, the AT&T Order, denying AT&T's request that the FCC find that VoIP services are exempt from switched access charges. The FCC held that an interexchange service that uses ordinary customer premises equipment that originates and terminates on the public switched telephone network, or PSTN, that provides no enhanced functionality, and that undergoes no net protocol conversion, is a telecommunications service and subject to switched access charges. The AT&T order apparently places interexchange services similar to those VoIP services offered by AT&T in the same regulatory category as traditional telecommunications services and, therefore, potentially subjects such VoIP services to access charges and other regulatory obligations including Universal Service fees. Although the FCC did not rule on the applicability of access charges for services provided prior to April 21, 2004, the ILECs may attempt to assert claims against other telecommunications companies including us for the retroactive payment of access charges. On April 22, 2004, SBC Communications filed a collections lawsuit against AT&T and other carriers seeking retroactive payment of unpaid access charges. On February 4, 2005, SBC amended an existing collection case it had filed against Global Crossing and filed a complaint against XO.

Level 3 Forbearance Petition. On December 23, 2003, Level 3 filed a petition requesting the FCC not to apply interstate or intrastate access charges on IP traffic that originates or terminates on the PSTN. Level 3 withdrew that petition on March 21, 2005, shortly before the FCC's statutory deadline for acting. Some observers have interpreted Level 3's withdrawal of the petition as a signal that the FCC was not likely to rule in Level 3's favor. The FCC may ultimately rule on this issue either in its VoIP rulemaking proceeding or in the intercarrier compensation reform proceeding discussed below. The issue of whether access charges apply to VoIP and other IP traffic that originates or terminates on the PSTN is potentially significant for XO and other carriers.

ILEC Provision of Broadband Telecommunications Services and Information Services. Currently, the ILECs, as dominant carriers, are subject to a relatively high degree of regulation with respect to their broadband service offerings. The FCC, however, has initiated a rulemaking proceeding in which it is considering deregulating, or applying a lower degree of regulation to, ILEC broadband offerings. If the ILECs are largely freed from dominant carrier regulation, they will have much greater pricing flexibility and will pose a greater competitive threat to XO. In a second, related rulemaking, the FCC is considering whether to eliminate certain requirements it imposes on the ILECs with respect to their broadband Internet access services. Currently, where the ILECs offer Internet access or other information services over broadband facilities, they must (1) purchase the underlying broadband transmission facilities from themselves at tariffed rates and (2) make the underlying facilities available to competitors on a non-discriminatory basis. If the FCC were to eliminate these requirements, it could result in an increase to our network costs. To date, these deregulatory trends have been directed towards facilities used primarily by residential customers, and not by business customers.

Intercarrier Compensation Reform. Currently, telecommunications carriers are required to pay other carriers for interstate access charges and local reciprocal compensation charges. These two forms of intercarrier compensation have been under review by the FCC since 2001. The FCC continues to consider a broad order reforming the intercarrier compensation system and issued a Notice of Proposed Rulemaking on February 10, 2005 to seek further comment on intercarrier compensation reform. Although we are unable to predict the outcome of the FCC's rulemaking procedures, inasmuch as access charges and reciprocal compensation payments make up our largest network expense item, the FCC's action could have a material, adverse affect on our operations and cost of doing business.

Cost-based TELRIC Pricing. On September 10, 2003, the FCC initiated a new proceeding to consider significantly revamping the current TELRIC methodology used for the pricing of UNEs. If the FCC reverses the methodology used for determining UNE rates to allow for rate increases, this could substantially raise XO's costs for leasing UNEs in the future. A decision is expected sometime in 2005. Several state commissions have also initiated proceedings to review the rates that the ILECs charge for UNEs. An adverse ruling in these proceedings would allow the ILECs to increase UNE rates in the applicable state and this could substantially raise our costs for leasing UNEs in the future.

State and Local Regulation

In general, state regulatory commissions have regulatory jurisdiction over us when our facilities and services are used to provide local and other intrastate services. Under the Telecom Act, state commissions continue to set the requirements for providers of local and intrastate services, including quality of services criteria. State regulatory commissions also can regulate the rates charged by CLECs for intrastate and local services and can set prices for interconnection by new telecommunications service providers with the ILEC networks, in accordance with guidelines established by the FCC. In addition, state regulatory commissions in many instances have authority under state law to adopt additional regulations governing local competition and consumer protection, as long as the state's actions are not inconsistent with federal law or regulation.

Most state regulatory commissions require companies that wish to provide intrastate common carrier services to register or be certified to provide these services. These certifications generally require a showing that the carrier has adequate financial, managerial and technical resources to offer the proposed services in a manner consistent with the public interest. We are certified in all of the states in which we conduct business. In most states, we are also required to file tariffs setting forth the terms, conditions and prices for services that are classified as intrastate, and to update or amend our tariffs as rates change or new products are added. We may also be subject to various reporting and record-keeping requirements.

Where we choose to deploy our own transmission facilities, we may be required, in some cities, to obtain street opening and construction permits, permission to use rights-of-way, zoning variances and other approvals from municipal authorities. We also may be required to obtain a franchise to place facilities in public rights-of-way. In some areas, we may be required to pay license or franchise fees for these approvals. We cannot provide assurances that fees will remain at current levels, or that our competitors will face the same expenses, although the Telecom Act requires that any fees charged by municipalities be reasonable and non-discriminatory among telecommunications carriers.

California Public Utilities Commission Proceeding. On September 23, 2004, the California Public Utilities Commission, or the CA Commission, issued a decision that required SBC to adjust monthly recurring rates for certain types of services offered to CLECs by SBC. As a result of that decision, we believed that we were owed a retroactive credit. The billing adjustments and true-up payments required by the decision had been stayed until the CA Commission could: (a) consider mitigations to lessen the negative effect of such true-up payments; and (b) consider issues raised by the U.S. Court of Appeals for the Ninth Circuit regarding the shared and common cost mark-up element. After issuance of the September 23, 2004 decision, the CA Commission issued three separate alternate draft decisions all of which proposed different true-up payment schemes and different shared and common cost mark-up factors as well as retroactive and non-retroactive treatment of the mark-up factor. These three alternate decisions were contentious and were being debated by the CA Commission and various parties to the proceeding.

On March 22, 2005 XO and SBC executed a settlement agreement resolving these issues. As a result of this settlement, on March 25, 2005 SBC made a payment to XO of approximately $10.0 million. The settlement agreement provides XO with finality on these issues as the settlement agreement prohibits SBC from seeking rehearing before the CA Commission or appealing to any state of federal court the true-up or payment of the true-up monies to XO.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We had $382.7 million in secured loans as of June 30, 2005. Currently, we do not pay cash interest on the loans under the Credit Facility. As interest accrues at variable rates, our Credit Facility subjects us to interest rate risks.

Marketable securities and other investments at June 30, 2005 consist primarily of investments in equity and debt investments of publicly-traded companies. The fair value of our investment in equity and debt securities exposes us to market risk; however, if the fair value were to increase or decrease immediately, it would not likely have a material impact on our financial position or our results of operations. We are not currently engaged in the use of off-balance sheet derivative financial instruments, to hedge or partially hedge interest rate exposure nor do we maintain any other off-balance sheet arrangements for the purposes of credit enhancement, hedging transactions, or other financial or investment purposes.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The term “disclosure controls and procedures” is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934. These rules refer to the controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. Our Principal Executive Officer and our Principal Financial Officer have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on the evaluation, they have concluded that, as of the end of such period, the controls and procedures were effective at ensuring that required information was accurate and disclosed on a timely basis in our report filed under the Exchange Act.

Changes in Internal Controls

We maintain a system of internal accounting controls that is designed to provide reasonable assurance that our books and records accurately reflect our transactions and that our established policies and procedures are followed.

During the first quarter of 2005, we implemented a new sales commissioning system and began migrating certain customers to a new billing system. We anticipate the migration of our customers to the new billing system will be completed in the third quarter of 2005. Additionally, we are in the process of combining the customer provisioning system acquired through the acquisition of the Acquired Businesses with the system of the legacy XO business. These actions have resulted in changes to our internal controls over financial reporting.

Except as noted above, there were no other changes to our internal controls that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are involved in lawsuits, claims, investigations and proceedings consisting of commercial, regulatory, securities, tort and employment matters, which arise in the ordinary course of business. In accordance with Statement of Financial Accounting Standards No. 5, “ Accounting for Contingencies,” we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We believe we have adequate provisions for any such matters. We review these provisions at least quarterly and adjust these provisions to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. However, we believe that we have valid defenses with respect to legal matters pending against the Company. Nevertheless, it is possible that cash flows or results of operations could be materially and adversely affected in any particular period by the unfavorable resolution of one or more of these contingencies.

We filed an administrative claim in August 2004 against the Allegiance Telecom Liquidating Trust (the “ATLT”). We have claimed that we are entitled to approximately $50 million in damages related to a variety of actions allegedly taken by Allegiance and the ATLT. The ATLT filed a counterclaim against us on November 24, 2004 seeking damages of approximately $100.0 million, which claim we believe to be frivolous and without merit. The case went to trial in the United States Bankruptcy Court for the Southern District of New York on May 2, 2005 and has not yet been decided.

Start Investments Inc, or Start, is XO Communications, Inc.’s, or XOC, 10% minority partner in Telecommunications of Nevada, or TON, a Nevada joint venture company whose results of operations are consolidated into the accompanying financial statements. XOC and Start hold promissory notes, collectively referred to as the Notes, from TON for $63.5 million, referred to as the XOC Note, and $7.1 million, referred to as the Start Note, respectively. The Notes became due in December 2002 and were not paid or extended on that date, but cannot be accelerated or foreclosed upon without the consent of XOC, which XOC has declined to give, acting in what it believes are the best interests of TON. TON has paid current interest on the Notes to both holders, but at the historic rate of interest, not the higher default rate. Start filed a suit against TON and XOC in the District Court for Clark County Nevada in October of 2003, which alleged that XOC had tortiously interfered with Start’s contractual relations with TON and breached its duty of good faith and fair dealing. The suit seeks temporary injunctive and declaratory relief, as well as damages of approximately $9.0 million, consisting primarily of the principal amount of the Start Note and interest at the default rate. In July 2005, Start moved to amend its complaint to add a claim against TON for breach of contract for failure to pay the Start Note. We believe we have valid defenses to the claims raised by Start and to its purported calculation of any damages. However, in the event that TON is required to pay the full principal amount of the Notes, absent a negotiated, out-of-court financial restructuring, TON may be forced to seek protection under chapter 11 of the Federal Bankruptcy Code, which could trigger a default on our Credit Facility.

The XOC Note and the accrued interest payable from TON to XOC, and the related note and interest receivable of XOC from TON, are intercompany balances and, in accordance with the principles of consolidation, have been eliminated in the consolidation of the financial statements. The Start Note and the related accrued interest payable, totaling approximately $8.3 million, are included in other current liabilities in our Condensed Consolidated Balance Sheet.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None.

Item 3. Defaults Upon Senior Securities

None.

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

The XO Communications, Inc. annual meeting of shareholders was held on May 9, 2005 in New York, New York.

At the 2005 annual meeting of shareholders, the shareholders elected the following individuals to the Board of Directors for the succeeding year and until their successors are duly qualified and elected:

	Votes For	Votes Withheld
Carl C. Icahn	129,371,004	1,117,934
Carl J. Grivner	129,382,705	1,106,233
Adam Dell	129,423,773	1,065,165
Vincent J. Intrieri	129,389,651	1,102,287
Keith Meister	129,387,177	1,101,761
Robert Knauss	129,420,266	1,068,672
Fredrik Gradin	129,425,819	1,063,119
Jon F. Weber	129,389,369	1,099,569

Item 5. Other Information

None.

Item 6. Exhibits

31.1 Rule 13a — 14(a)/15(d) — 14(a) Certification

31.2 Rule 13a — 14(a)/15(d) — 14(a) Certification

32.1 Certificate pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certificate pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrants have duly caused this report to be signed on their behalf by the undersigned thereunto duly authorized.

XO Communications, Inc.

Date: August 9, 2005

By: /s/ William Garrahan
William Garrahan
Senior Vice President and
Acting Chief Financial Officer
(Principal Financial Officer)