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April 3, 2001

Arizona Corporation Commission
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AZ CORP COMMISSION
DOCUMENT CONTROL

VIA OVERNIGHT DELIVERY

Arizona Corporation Commission
Docket Control Center
1200 West Washington Street
Phoenix, AZ 85007-2996

Re: **Docket No. T-04000A-01-0208:** Application and Petition of Telseon Carrier Services, Inc. for a Certificate of Convenience and Necessity to Provide Resold and Facilities-Based Local Exchange, Exchange Access, and Interexchange Telecommunications Service in Arizona

Dear Sir or Madame:

On behalf of Telseon Carrier Services, Inc. ("Telseon"), enclosed please find an original and ten (10) copies of Telseon's response to Staff's Sufficiency Review Notice (the "Notice").

In response to item number four (4) in the Notice, Telseon states that it does not have any affiliated alternative providers of interexchange or access services operating in Arizona.

Please date stamp the enclosed extra copy of this filing and return it in the self-addressed, postage-paid envelope provided. Should you have any questions concerning this filing, please do not hesitate to contact Alexander Stokas at 202/295-8354.

Respectfully submitted,

Rogena Harris
Alexander Stokas

Counsel for Telseon Carrier Services, Inc.

Enclosures

cc: Steve Miller (w/encl.)

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TELSEON, INC.
(formerly Cmetric, Inc.)

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REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and
Stockholders of Telseon, Inc. (formerly Cmetric, Inc.)

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in stockholders' deficit and of cash flows present fairly, in all material respects, the financial position of Telseon, Inc. (formerly Cmetric, Inc.) (a development stage enterprise) and its subsidiaries at December 31, 1999, and the results of their operations and their cash flows for the year then ended and for the period from inception on December 18, 1998 through December 31, 1999, in conformity with accounting principles generally accepted in the United States. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

August 29, 2000
San Francisco, California

TELSEON, INC. (formerly Cmetric, Inc.)
(A Development Stage Enterprise)

CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)

	December 31, 1999	June 30, 2000 (unaudited)
Assets		
Current assets		
Cash and cash equivalents	$ 3,670	$ 56,288
Accounts receivable	—	21
Prepaid fiber	—	12,153
Other prepaid expenses and other current assets	108	1,037
Total current assets	3,778	69,499
Property and equipment, net	1,610	23,429
Capitalized software development, net	494	1,393
Capitalized web site development, net	—	147
Other assets	43	2,182
Total assets	$ 5,925	$ 96,650
Liabilities, redeemable convertible preferred stock and stockholders' deficit		
Current liabilities		
Accounts payable	$ 234	$ 2,229
Accrued liabilities	796	3,331
Current portion of capital lease obligations	14	283
Total current liabilities	1,044	5,843
Capital lease obligations, net of current portion	33	15,582
Total liabilities	1,077	21,425
Commitments (Note 11)		
Redeemable convertible preferred stock; $0.0001 par value; 40,500,000 shares authorized, 40,279,221 shares issued and outstanding at June 30, 2000; 19,500,000 shares issued and outstanding December 31, 1999 (Liquidation value: $6,500,000 as of December 31, 1999 and $86,500,000 as of June 30, 2000)	6,421	86,311
Stockholders' deficit		
Common stock, $0.0001 par value; 100,000,000 shares authorized, 15,710,025 shares issued and outstanding at June 30, 2000; 60,000,000 authorized, 8,377,500 shares issued and outstanding at December 31, 1999	1	1
Additional paid-in capital	3,100	28,294
Deferred stock-based compensation, net	(2,497)	(18,741)
Notes receivable for common stock	—	(2,288)
Deficit accumulated during the development stage	(2,177)	(18,352)
Total stockholders' deficit	(1,573)	(11,086)
Total liabilities, redeemable convertible preferred stock and stockholders' deficit	$ 5,925	$ 96,650

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

TELSEON, INC. (formerly Cmetric, Inc.)
(A Development Stage Enterprise)

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except share and per share amounts)

	Period from inception (December 18, 1998) and for the year ended December 31, 1999	Six months ended June 30, 1999 (unaudited)	Six months ended June 30, 2000 (unaudited)	Period from inception (December 18, 1998) to June 30, 2000
Revenues	$ —	$ —	$ 28	$ 28
Operating cost and expenses				
Network expenses	—	—	201	201
Selling, marketing, general and administrative	1,722	309	9,681	11,403
Stock-based compensation	566	51	6,272	6,838
Depreciation and amortization	48	1	498	546
Total operating costs and expenses	2,336	361	16,652	18,988
Loss from operations	(2,336)	(361)	(16,624)	(18,960)
Interest income	162	33	930	1,092
Interest expense	(3)	(1)	(481)	(484)
Net loss	$(2,177)	$(329)	$ (16,175)	$(18,352)
Per share information				
Net loss per common share: basic and diluted	$(62.52)	$ —	$ (8.99)	
Common shares used in computing per share amounts: basic and diluted	34,821	—	1,798,985	

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

TELSEON, INC. (formerly Cmetric, Inc.)
(A Development Stage Enterprise)

CONSOLIDATED STATEMENT OF CHANGES IN REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' DEFICIT
(in thousands, except share amounts)

	Preferred Stock Redeemable Convertible		Common Stock		Deferred Stock-Based Compensation	Additional Paid-In Capital	Notes Receivable	Deficit Accumulated During the Development Stage	Total
	Shares	Amount	Shares	Par Value					
Balance, December 18, 1998 (inception)	—	$ —	—	$—	$ —	$ —	$ —	$ —	$ —
Issuance of common stock to founder	—	—	3,900,000	—	—	1	—	—	1
Issuance of Series A redeemable convertible preferred stock for cash and debt repayment, net of issuance costs of $36	19,500,000	6,421	—	—	—	—	—	—	—
Issuance of common stock pursuant to the exercise of stock options	—	—	4,477,500	1	—	36	—	—	37
Deferred stock-based compensation	—	—	—	—	(3,063)	3,063	—	—	—
Amortization of deferred stock-based compensation	—	—	—	—	566	—	—	—	566
Net loss	—	—	—	—	—	—	—	(2,177)	(2,177)
Balance, January 1, 2000	19,500,000	6,421	8,377,500	1	(2,497)	3,100	—	(2,177)	(1,573)
Issuance of Series B redeemable convertible preferred stock for cash and debt repayment, net of issuance costs of $110	20,779,221	79,890	—	—	—	—	—	—	—
Issuance of common stock pursuant to the exercise of stock options	—	—	7,191,250	—	—	2,322	(2,288)	—	34
Issuance of common stock	—	—	141,275	—	—	56	—	—	56
Beneficial conversion feature related to conversion of promissory notes into shares of common stock	—	—	—	—	—	300	—	—	300
Deferred stock-based compensation	—	—	—	—	(22,475)	22,516	—	—	41
Amortization of deferred stock-based compensation	—	—	—	—	6,231	—	—	—	6,231
Net loss	—	—	—	—	—	—	—	(16,175)	(16,175)
Balance at June 30, 2000	40,279,221	$86,311	15,710,025	$ 1	$(18,741)	$28,294	$ (2,288)	$(18,352)	$(11,086)

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

TELSEON, INC. (formerly Cmetric, Inc.)
(A Development Stage Enterprise)

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Period from inception (December 18, 1998) and for the year ended December 31, 1999	Six months ended June 30, 1999 (unaudited)	Six months ended June 30, 2000 (unaudited)	Period from inception (December 18, 1998) to June 30, 2000
Cash flows from operating activities				
Net loss	$(2,177)	$ (329)	$(16,175)	$ (18,352)
Adjustments to reconcile net loss to net cash used in operating activities				
Depreciation and amortization	48	1	498	546
Amortization of deferred stock-based compensation	566	51	6,272	6,838
Beneficial conversion feature	—	—	300	300
Changes in assets and liabilities				
Accounts receivable	—	—	(21)	(21)
Prepaid fiber	—	—	(7,153)	(7,153)
Prepaid expenses and other current assets	(108)	(22)	(929)	(1,037)
Accounts payable	234	—	1,995	2,229
Accrued liabilities	359	103	2,161	2,520
Other assets	(43)	—	(2,139)	(2,182)
Net cash used in operating activities	(1,121)	(196)	(15,191)	(16,312)
Cash flows from investing activities				
Purchases of property and equipment	(1,170)	(109)	(5,966)	(7,136)
Capitalized software development	(494)	—	(1,011)	(1,505)
Capitalized web site development	—	—	(159)	(159)
Net cash used in investing activities	(1,664)	(109)	(7,136)	(8,800)
Cash flows from financing activities				
Principal payments on capital lease obligations	(4)	—	(35)	(39)
Proceeds from issuance of convertible preferred stock, net of issuance cost	6,421	6,423	74,890	81,311
Proceeds from issuance of common stock	1	1	56	57
Proceeds from the exercise of stock options	37	1	34	71
Net cash provided by financing activities	6,455	6,425	74,945	81,400
Net increase in cash and cash equivalents	3,670	6,120	52,618	56,288
Cash and cash equivalents, beginning of period	—	—	3,670	—
Cash and cash equivalents, end of period	$ 3,670	$6,120	$ 56,288	$ 56,288
Supplemental disclosure of cash flow information				
Cash paid for interest	$ 3	$ 1	$ 481	$ 484
Acquisition of property and equipment under capital leases	$ 51	$ —	$ 15,853	$ 15,904
Stock-based compensation expense	$ 3,063	$ 360	$ 22,475	$ 25,538
Notes receivable on common stock	$ —	$ —	$ 2,288	$ 2,288
Issuance of convertible preferred stock in exchange for fiber	$ —	$ —	$ 5,000	$ 5,000

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

TELSEON, INC. (formerly Cmetric, Inc.)
(A Development Stage Enterprise)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
For the year ended December 31, 1999 (information as of June 30, 1999 and 2000 and for the six months ended June 30, 1999 and 2000 is unaudited)

1. Organization and Nature of the Business

Organization

Telseon, Inc. and Subsidiaries (the "Company"), formerly Cmetric, Inc., was incorporated on December 18, 1998, in the state of Delaware; costs incurred during the period from December 18, 1998 through December 31, 1998 were $18,000 and are included in the 1999 consolidated statement of operations.

The Company incurred a cumulative loss of $18,352,000 since its inception through June 30, 2000. The Company expects to make significant capital expenditures and to continue to incur significant losses in the foreseeable future. To fund its anticipated operating losses, capital expenditures and interest expense through the end of 2000 and to execute its business plan, the Company plans to raise significant capital. There can be no assurance that management will be successful in carrying out its plans. If the risks listed above cannot be managed in a timely manner, the Company may be forced to curtail further development and apply available funds to complete current projects and operate on a smaller scale.

Nature of the business

The Company is a facilities-based broadband Internet infrastructure service provider. The Company offers high-speed services across metropolitan area networks to service providers and enterprise customers. Since its inception, the Company has devoted substantially all its efforts to developing and executing its business plan; developing and implementing its network architecture and operations support systems; recruiting management, technical staff and other key personnel; negotiating agreements for equipment and fiber; acquiring equipment and space in co-location facilities and other operating assets; and raising capital. Accordingly, the Company is considered to be in the development stage as defined in Statement of Financial Accounting Standards ("SFAS") No. 7.

2. Summary of Significant Accounting Policies

Interim financial information

The interim financial data as of June 30, 2000, and for the six-months ended June 30, 1999 and 2000, is unaudited. However, in the opinion of the Company, the interim data includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim periods. The results for the six month periods ended June 30, are not necessarily indicative of the results to be expected for any year.

Principles of consolidation

The consolidated financial statements include the accounts of Telseon, Inc. and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in the consolidated financial statements.

Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts

of assets and liabilities, contingent assets and liabilities and revenues and expenses during the period. Actual results could differ from those estimates.

Cash and cash equivalents

The Company considers all highly liquid investments with a maturity of three months or less at the date of purchase to be cash equivalents. Such cash equivalents primarily consist of money market instruments and are stated at amortized cost plus accrued interest, which approximates fair value.

Fair value of financial instruments

The carrying amounts of the Company's financial instruments, which include cash and cash equivalents, accounts payable and accrued liabilities approximate their fair values due to their short maturities.

Concentration of credit risk

Financial instruments that may potentially subject the Company to a concentration of credit risk consist principally of cash and cash equivalents. All cash and cash equivalents are deposited with financial institutions with strong credit ratings. The Company has not experienced any losses due to credit impairment related to its financial instruments.

Segment reporting

The Company has adopted the provisions of SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information.* SFAS No. 131 establishes annual and interim reporting standards for operating segments of a company. The statement requires disclosures of selected segment-related financial information about products, major customers and geographic areas. The Company has one reportable segment.

Property and equipment

Property and equipment are carried at cost. Depreciation and amortization of property and equipment are computed using the straight-line method over the following estimated useful lives:

Fiber optic network assets	1 – 20 years
Leasehold improvements	Life of lease
Furniture, fixtures and equipment	2 – 8 years

Upon retirement or sale, the cost of assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is credited or charged to operations. Repairs and maintenance costs are expensed as incurred.

Long-lived assets

Statement of Financial Accounting Standards No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of,* requires that long-lived assets and certain intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If fair market values are less than the carrying value

of the assets, an impairment loss is to be recognized based on the fair value of the assets. No impairment losses have been recognized to date.

Construction in progress

Capitalized construction costs include: costs incurred under a construction contract; cabling; engineering labor and construction management, including related payroll taxes and benefits; rent; utilities; other direct costs and interest during the construction phase. Once a metropolitan fiber optic network has been constructed, capitalized costs are depreciated over their estimated useful life. The Company capitalized $336,000 and $551,000 of direct labor and associated overhead in the year ended December 31, 1999 and the six months ended June 30, 2000, respectively. Interest incurred during construction is capitalized in accordance with SFAS No. 34, *Capitalization of Interest Costs*. No interest was capitalized during the year ended December 31, 1999 or for the six months ended June 30, 2000.

Capitalized software development costs

Costs associated with computer software developed for the Company's internal use, primarily development of the Company's operational systems, are recorded in accordance with SOP 98-1, *Accounting for the Cost of Computer Software Developed or Obtained for Internal Use*. Costs incurred in the preliminary project stage are expensed as incurred, while costs incurred during the application development stage are capitalized. Capitalization ceases when the computer software is ready for its intended use.

Costs of internal use software are amortized on a straight-line basis from the date of commencement of service over the estimated useful life of the software, generally six months to two years. Amortization expense was $0 for the year ended December 31, 1999 and $112,000 for the six months ended June 30, 2000.

Capitalized web site development costs

Costs incurred in the design, creation and maintenance of content, graphics and user interface of the Company's web sites are expensed as incurred in accordance with SOP 98-1, *Accounting for the Cost of Computer Software Developed or Obtained for Internal Use*. Costs incurred in the development of application and infrastructure of the web sites are capitalized and amortized over the useful life of the web sites.

Revenue recognition

The Company enters into contracts with its customers for fiber optic transmission and connection services within metropolitan areas. These contracts typically have a term of one year with varying renewal periods. The Company's revenue consists primarily of monthly payments for network access charges and payments for connecting customers to communications carriers. Generally, the Company bills in advance of service. Related revenue is deferred and recognized on a straight-line basis over the period in which service is provided. Revenue also includes payments for customer installation, which is recognized as revenue over the estimated life of the customer relationship, and other services that are recognized as the services are rendered.

Network expenses

Network expenses consist of costs related to co-location facilities and fiber. Costs related to co-location facilities include building entrance, interconnection and rental of equipment rack space. Costs related to fiber include lease, operating and maintenance expenses.

Accounting for stock-based compensation

The Company accounts for stock-based compensation issued to employees using Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, and provides pro forma disclosures as required under SFAS No. 123, *Accounting for Stock-Based Compensation*. Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of the Company's stock and the exercise price of the option. Stock, stock options and warrants for stock issued to non-employees are accounted for in accordance with the provisions of SFAS No. 123 and *Emerging Issues Task Force ("EITF") Issue 96-18, Accounting for Equity Instruments that are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.*

Net loss per common share

The Company computes net loss per common share in accordance with SFAS No. 128, *Earnings Per Share*. Under the provisions of SFAS No. 128, basic net loss per common share (Basic EPS) is computed by dividing net loss by the weighted average number of common shares outstanding. Diluted net loss per common share (Diluted EPS) is computed by dividing net loss by the weighted average number of common shares and dilutive common share equivalents then outstanding.

	Period from inception (December 18, 1998) and for the year ended December 31, 1999	Six months ended June 30, 1999	Six months ended June 30, 2000
Net loss	$(2,177,000)	$ (329,000)	$(16,175,000)
Basic and diluted			
Weighted average shares of common stock outstanding	5,654,708	3,504,292	13,039,883
Less weighted average shares subject to repurchase	(5,619,887)	(3,504,292)	(11,240,898)
Weighted average shares used in computing basic and diluted net loss per share	34,821	—	1,798,985
Basic and diluted net loss per share	$ (62.52)	$ —	$ (8.99)

Diluted EPS for all periods presented does not include the impact of stock options and convertible preferred stock, as the effect would be antidilutive.

The following table sets forth potential common shares that are not included in the diluted net loss per share calculation above because to do so would be antidilutive:

	Period from inception (December 18, 1998) and for the year ended December 31, 1999	Six months ended June 30, 1999	Six months ended June 30, 2000
Convertible preferred stock upon conversion to common stock	11,916,667	4,333,333	28,947,591
Unvested common shares subject to repurchase	5,619,887	3,504,292	11,240,898
Options to purchase common stock	160,165	310,416	1,037,712
	17,696,719	8,148,041	41,226,201

Comprehensive Income

SFAS No. 130, *Reporting Comprehensive Income,* requires a full set of general purpose financial statements to include the reporting of "comprehensive income." Comprehensive income is comprised of two components: net income and other comprehensive income. For the year ended December 31, 1999 and for the six-months ended June 30, 2000, the Company had no other comprehensive income.

Recently issued accounting standards

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, *Accounting for Derivatives and Hedging Activities,* which establishes accounting and reporting standards of derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. Subsequently, in June 1999, the FASB issued SFAS No. 137, *Accounting for Derivatives and Hedging Activities — Deferral of the Effective Date of SFAS No. 133,* which amended SFAS No. 133. The Company does not currently have any derivatives or hedges and does not expect the adoption of this standard to have a material effect on the Company's results of operations, financial position or cash flows.

In December 1999, the SEC staff released SAB No. 101, *Revenue Recognition in Financial Statements.* SAB 101 provides interpretive guidance on the recognition, presentation, and disclosure of revenue in the financial statements. SAB 101, as amended by SAB 101A and SAB 101B, must be applied to the financial statements no later than the fourth quarter of 2000. The Company has implemented the guidance included in SAB 101 in these financial statements.

In March 2000, the Financial Accounting Standards Board issued Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation — an Interpretation of APB Opinion No. 25* ("FIN 44"). This Interpretation clarifies the definition of employee for purposes of applying Accounting Practice Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), the criteria for determining whether a plan qualifies as a noncompensatory plan, the accounting consequence of various modifications to the terms of a previously fixed stock option or award, and the accounting for an exchange of stock compensation awards in a business combination. This

Interpretation is effective July 1, 2000, but certain conclusions in this Interpretation cover specific events that occur after either December 15, 1998 or January 12, 2000. Management believes that FIN 44 did not and will not have a material effect on the financial position or results of operations of the Company.

3. Property and Equipment

Property and equipment consists of:

	December 31, 1999	June 30, 2000
Revenue producing assets		
Fiber optic network assets		
Fiber	$ —	$15,974,000
Fiber optic equipment	—	92,000
Switch equipment	526,000	2,184,000
Cabinets	—	182,000
Construction-in-process	798,000	2,375,000
Non-revenue producing assets		
Furniture, fixtures and office equipment	216,000	1,870,000
Leasehold improvements	47,000	547,000
Machinery and equipment	71,000	627,000
Total property and equipment	1,658,000	23,851,000
Less: accumulated depreciation and amortization	(48,000)	(422,000)
Net property and equipment	$1,610,000	$23,429,000

Included in property and equipment are assets financed under capital lease obligations of $51,000 and $15,904,000, at December 31, 1999 and June 30, 2000, respectively. Accumulated amortization related to assets under capital leases was $7,000 at December 31, 1999 and $45,000 at June 30, 2000.

Depreciation and amortization expense related to equipment acquired under capital leases for the year ended December 31, 1999 and the six months ended June 30, 2000 was $48,000 and $374,000, respectively.

4. Prepaid Fiber

During the six-months ended June 30, 2000, the Company entered into a capital lease agreement that provided the Company an indefeasible right to use certain fiber optic equipment (IRU) through April 2020. Through the six-months ended June 30, 2000, the Company has paid $6,712,000 in cash and exchanged $5,000,000 in 1,298,701 shares of the Company's Series B preferred stock for fiber with a fair value of $5,000,000. Additional commitments in terms of the IRU agreement amount to $18,637,625, which is payable as the fiber becomes available to the Company. The Company has not taken delivery of any of the fiber optics and, accordingly, has recorded the consideration as a prepayment at June 30, 2000.

5. Accrued Liabilities

Accrued liabilities consist of:

	December 31, 1999	June 30, 2000
Accrued capital expenditures	$437,000	$ 812,000
Payroll and payroll-related	158,000	1,279,000
Legal and accounting	104,000	254,000
Consulting accruals	50,000	188,000
Other	47,000	428,000
Marketing accruals	—	370,000
	$796,000	$3,331,000

6. Bridge Loans with Related Parties

In March and April 1999, the Company issued $130,000 in convertible promissory notes (the Series A Bridge Loans), which accrued interest at 5% per annum. The Series A Bridge Loans were converted in May 1999 into 520,000 shares of Series A redeemable convertible preferred stock at a value of $0.25 per share.

During February and March 2000 the Company issued $600,000 in convertible promissory notes (the "Loans") to a director and an advisory board member of the Company. The notes accrued interest at 5% per annum and were converted to shares of the Company's Series B redeemable convertible preferred stock and shares of the Company's common stock at March 31, 2000. Accordingly, the February $500,000 convertible promissory note was converted into 119,523 shares of common stock and 120,406 shares of Series B redeemable convertible preferred stock. The March $100,000 convertible promissory note was converted into 21,752 shares of common stock and 21,751 shares of Series B redeemable convertible preferred stock. The Company has determined that the fair value of the preferred stock in February and March was $3.85 per share, and the fair values of the shares of common stock was $2.48 and $2.74, respectively. As a result, the Company has recorded a beneficial conversion feature of $300,000 at the respective issue dates of the loans. The $300,000 has been recorded as interest expense in the six months ended June 30, 2000, in accordance of EITF Issue 98-5, *Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios.*

7. Redeemable Convertible Preferred Stock and Stockholders' Deficit

Effective March 13, 2000, the Company split the outstanding and authorized shares on a three-for-one basis. All share and per share information has been restated to reflect the effect of the stock split.

The Company has authorized 140,500,000 shares for issuance and designated 100,000,000 shares as Common Stock and 40,500,000 shares as preferred stock.

Redeemable Convertible preferred stock

In May 1999, the Company sold 520,000 shares of redeemable convertible preferred stock as Series A redeemable convertible preferred stock (the "Series A Preferred Stock") at $0.25 per share

in exchange for conversion of promissory notes of $130,000 (see Note 6) and 18,980,000 shares of Series A redeemable convertible preferred stock at $0.3333 per share for cash of $6,291,000, net of issuance costs of approximately $36,000.

In March and April 2000, a total of 20,779,221 shares of Series B redeemable convertible preferred stock (the "Series B Preferred Stock") were sold at $3.85 per share in exchange for conversion of promissory notes of $547,000, $5,000,000 in consideration for fiber to be delivered to the Company (see Note 4) and cash of $74,343,000, net of issuance costs of approximately $110,000.

The following table summarizes convertible preferred stock at June 30, 2000:

	Shares		Liquidation Amount	Net Proceeds
	Designated	Outstanding		
Series A	19,500,000	19,500,000	$ 6,500,000	$ 6,421,000
Series B	21,000,000	20,779,221	80,000,000	79,890,000
	40,500,000	40,279,221	$86,500,000	$86,311,000

The Series A and B preferred stock features are set forth in the Company's amended and restated Certificate of Incorporation, and are summarized as follows:

Voting

The holders of the preferred stock are entitled to vote, together with the holders of common stock, on all matters submitted to stockholders for a vote. Each preferred stockholder is entitled to the number of votes equal to the number of shares of common stock into which each preferred share is convertible at the time of such vote.

Dividends

The holders of the Series A Preferred Stock and Series B Preferred Stock are entitled to receive, when and as declared by the Board of Directors and out of funds legally available, noncumulative dividends at the rate of $0.0266 and $0.308, respectively, per share per annum, payable in preference and priority to any payment of any dividend on common stock. To date, no dividends have been declared or paid by the Company.

Liquidation preference

In the event of any liquidation, dissolution or winding up of the affairs of the Company, the holders of the Series A and Series B Preferred Stock are entitled to receive, in preference of common stock stockholders, an amount of $0.3333 and $3.85 per share, respectively, plus all declared but unpaid dividends. In addition, the Series B stockholders will participate in any distribution to the common stockholders on a pro rata basis until aggregate amounts of $7.70 per share have been distributed to Series B stockholders; thereafter, any remaining assets will be distributed to the common stockholders.

Conversion

Each share of preferred stock, at the option of the holder, is convertible into a number of fully paid shares of common stock as determined by dividing the respective preferred stock issue price by

the conversion price in effect at the time. The initial conversion price of Series A and Series B Preferred Stock is $0.3333 and $3.85, respectively, and is subject to adjustment in accordance with antidilution provisions contained in the Company's Certificate of Incorporation. Conversion is automatic immediately upon the closing of a firm commitment underwritten public offering in which the aggregate proceeds raised exceed $30,000,000. At June 30, 2000, 40,500,000 shares of the Company's common stock have been reserved for conversion.

Common stock

Each share of common stock is entitled to one vote. The holders of common stock are also entitled to receive dividends whenever funds are legally available and when declared by the Board of Directors, subject to the prior rights of holders of all classes of stock outstanding.

In January and May 1999, the Company issued 3,900,000 shares of its common stock to a founder under restricted stock purchase agreements at $0.0003 per share. There are repurchase provisions in the event of termination of employment. The shares are released from the repurchase provisions ratably over four years. Common stock as of December 31, 1999 includes 2,925,000 shares subject to repurchase.

At June 30, 2000, notes receivable from stockholders consists of notes receivable of $2,288,000 from certain officers and other employees of the Company issued for the exercise of stock purchase rights. These full recourse notes bear interest at between 6.30% and 6.69%, are collateralized, in part, by common stock and are due four years from the issue dates. The stock sold in connection with these notes and other option exercises are subject to repurchase by the Company at the original issuance price; this right generally lapses over a four-year period subject to continued employment. At December 31, 1999, 7,402,500 shares of common stock were subject to this repurchase right, including 2,925,000 shares of restricted stock issued to founders and 4,477,500 shares issued upon the exercise of employee stock options.

Common stock warrant

In connection with a facility leasing agreement entered into in April 2000, the Company agreed to issue a 10 year warrant to purchase 96,780 shares of Common Stock at an exercise price of $3.85 per share. At June 30, 2000, the Company has not yet issued this warrant, which, based on the Black-Scholes options pricing model, is valued at $3.99 per share.

8. Stock Option and Stock Purchase Plans

In 1999, the Company adopted the 1999 Stock Plan (the "1999 Plan"), under which 7,600,000 shares (as adjusted to reflect a transfer of 2,000,000 shares to the 2000 Executive Stock Purchase Plan) of the Company's common stock were reserved for issuance to employees, directors and consultants. Options granted under the 1999 Plan may be incentive stock options or non-statutory stock options. Stock purchase rights may also be granted under the 1999 Plan. Incentive stock options may only be granted to employees. The Board of Directors determines the period over which options become exercisable, however, except in the case of options granted to officers, directors and consultants, options shall become exercisable at a rate of not less than 25% per year over four years from the date the options are granted. The exercise price of incentive stock options and nonstatutory stock options shall be no less than 100% and 85%, respectively, of the fair market value per share of the Company's common stock on the grant date. If an individual owns stock representing more than 10% of the outstanding shares, the price of each share shall be at least 110% of fair market value, as determined by the Board of Directors. The term of the options is ten years.

In 2000, the Company adopted the 2000 Executive Stock Purchase Plan, under which 8,000,000 shares, including 2,000,000 shares transferred from the 1999 Stock Option Plan, of the Company's common stock were reserved for the sale to employees, directors and consultants, upon exercise of stock purchase rights granted to such employees, directors and consultants. The terms of the stock purchase rights is ten years.

SFAS No. 123, *Accounting for Stock-Based Compensation,* encourages adoption of a fair value-based method for valuing the cost of stock-based compensation. However, it allows companies to continue to use the intrinsic value method under APB No. 25 for options granted to employees and disclose pro forma net earnings and earnings per share in accordance with SFAS No. 123. Had compensation cost for the Company's stock-based compensation plans been determined consistent with SFAS No. 123, the Company's net loss and loss per share would have been as follows:

	Year ended December 31, 1999
Net loss as reported	$(2,177,000)
Pro forma net loss	$(2,255,000)
Net loss per share as reported, basic and diluted	$ (62.52)
Pro forma net loss per share, basic and diluted	$ (64.76)

The weighted average fair value of stock options granted during the year ended December 31, 1999 was $0.01.

The effects of applying SFAS No. 123 for the pro forma disclosures are not representative of the effects expected on reported net earnings and earnings per share in future years, since valuations are based on highly subjective assumptions about the future, including stock price volatility and exercise patterns.

The Company used the Black-Scholes option pricing model to determine the fair value of grants. The following assumptions were applied in determining the pro forma compensation cost:

	Year ended December 31, 1999
Weighted average risk-free interest rate	5.5%
Expected dividend yield	0%
Expected option life in years	5

Stock-based compensation

In connection with certain stock purchase rights and stock options granted to employees and board members, the Company recorded approximately $3,063,000, and $22,475,000 of unearned stock-based compensation for the excess of the deemed fair market value over the exercise price at the date of grant for the year ended December 31, 1999 and for the six months ended June 30, 2000, respectively. The compensation expense is being recognized, using the multiple option method as prescribed by FASB Interpretation No. 28, over the vesting period of the respective equity instrument, generally four years. As a result, the Company recorded stock-based compensation expense of $566,000, and $6,272,000 for the year ended December 31, 1999 and for the six months ended June 30, 2000, respectively.

The following table summarizes the activity of the Company's Plans:

		December 31, 1999	
	Shares Available for Grant	Number of Options	Weighted Average Exercise Price
Authorized	15,600,000	—	
Granted	(5,557,500)	5,557,500	$0.0131
Exercised	—	(4,477,500)	$0.0082
Cancelled	67,500	(67,500)	$0.0333
Outstanding, December 31, 1999	10,110,000	1,012,500	$0.0333
Granted	(9,162,844)	9,162,844	$ 0.64
Exercised	—	(7,191,250)	$ 0.33
Cancelled	51,000	(51,000)	$ 0.10
Outstanding, June 30, 2000	998,156	2,933,094	$ 1.19
Exercisable and vested at December 31, 1999		1,250	
Weighted average grant date fair value for the year ended December 31, 1999		$ 0.0333	

The following table summarizes information about equity instruments outstanding at December 31, 1999:

	Options Outstanding			Options Exercisable	
Range of Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$0.0333	1,012,500	9.93	$0.0333	1,250	$0.0333

Certain options are exercisable prior to vesting. At December 31, 1999, options to purchase 804,000 shares are exercisable, but unvested.

9. Income Taxes

At December 31, 1999, the Company had net operating loss carryforwards of approximately $2,625,000 and $2,623,000 for federal and state income tax purposes, respectively, which begin to expire in the years 2006 and 2019, respectively. In addition, due to changes in the Company's ownership in 1999, the amount of net operating losses available to offset future federal income tax liabilities may be limited. The amount of such limitation, if any, has not been determined.

The Company has approximately $219,000 of deferred tax assets within the net operating loss carryforwards attributable to tax deductions from exercise of non-qualified stock options in excess of the book expense recorded to date. When the tax benefit is realized, the benefit will be recorded as additional paid-in capital and not reflected in the effective tax rate.

Deferred tax assets consist of the following:

	December 31, 1999
Net operating loss carryforwards	$1,046,000
Other	50,000
Depreciation and amortization	(31,000)
Deferred stock-based compensation	(224,000)
	841,000
Deferred tax asset valuation allowance	(841,000)
Net deferred tax assets	$ —

Due to the uncertainty surrounding the realization of the favorable tax attributes in future tax returns, the Company has placed a valuation allowance against its net deferred tax asset. Since the Company had nominal activity from inception through the period ended December 31, 1998, the valuation allowance recorded for the period ended December 31, 1999 is the Company's total valuation allowance.

The difference between the income tax benefit at the statutory rate of 34% and the Company's effective tax rate is due primarily to the valuation allowance established to offset the deferred tax assets. The provision for income taxes is different than the amount computed using the applicable statutory federal income tax rate with the difference summarized below:

	December 31, 1999
Federal tax benefit at statutory rate	(34)
State taxes, net of Federal benefit	(6)
Adjustment due to the valuation allowance	39
Permanent differences	1
Provision for income taxes	—

10. 401(k) Savings Plan

During 2000, the Company established a defined contribution savings plan under Section 401(k) of the Internal Revenue Code. This plan covers substantially all employees who meet minimum age and service requirements and allows participants to defer a portion of their annual compensation on a pre-tax basis. Company contributions to the plan may be made at the discretion of the Board of Directors. To date there were no contributions made to the plan by the Company.

11. Commitments

The Company leases its office space, fiber and certain office equipment under noncancelable operating leases. Total rent expense under these operating leases was approximately $97,000 for the year ended December 31, 1999.

Future minimum lease payments under capital leases and noncancelable operating leases at December 31, 1999 are as follows:

Year ending December 31,	Operating Leases	Capital Leases
2000	$246,000	$ 22,000
2001	239,000	22,000
2002	10,000	16,000
2003	—	3,000
Total minimum lease payments	$495,000	63,000
Less: amount representing interest		(16,000)
Principal balance of capital lease obligations		47,000
Less: current portion of capital lease obligations		(14,000)
Long-term portion of capital lease obligations		$ 33,000

The Company invests in fiber optic cable systems by obtaining indefeasible rights of use ("IRU's") or bandwidth capacity agreements. During the six months ended June 30, 2000, the Company entered into two IRU agreements, which are treated as capital leases. As a result of these transactions, the Company has recorded fiber optic cable assets and a future lease liability of $15,845,000. Future minimum lease payments associated with these transactions are $1,120,000, $1,836,000 $1,836,000, $1,836,000, $1,836,000 and $28,256,000 for calendar year 2000, 2001, 2002, 2003, 2004 and thereafter, respectively.

During the six months ended June 30, 2000, the Company also entered into various operating leases, primarily facilities rental agreements. Lease payments associated with these transactions are $993,000, $2,076,000, $2,173,000, $2,235,000, $2,298,000 and $11,669,000 for the calendar year 2000, 2001, 2002, 2003, 2004 and thereafter, respectively. One such facility leasing agreement includes a commitment to issue a 96,780 common stock warrant valued at $3.27 each (see Note 7).

Risks and uncertainties

The Company's future results of operations involve a number of risks and uncertainties. Factors that could effect the Company's future operating results and cause actual results to differ materially from expectations include, but are not limited to, dependence on few customers, competition, new products, changes in regulations, strategic relationships, dependence upon key personnel, and the Company's ability to fund and manage growth.

The Company currently sells its services to a limited number of customers. For the six-month period ended June 30, 2000, one customer accounted for approximately 76% of revenue and two customers accounted for the remaining 24% of revenue. At June 30, 2000, one customer accounted for 100% of accounts receivable.

The Company currently relies on limited sources of supply for key components of its network, operating support and administration infrastructure. Although there are a limited number of suppliers, management believes that other suppliers could provide similar products on comparable terms. A change in suppliers, however, could cause a delay in developing its network and a possible loss of sales, which would affect operating results adversely.