BOULT CUMMINGS CONNERS & BERRY PLC

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OFFICE OF THE
EXECUTIVE SECRETARY

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May 11, 1999

K. David Waddell
Executive Secretary
Tennessee Regulatory Authority
460 James Robertson Parkway
Nashville, TN 37243-0505

Re: Application of ACI Corp. for a Certificate of Public Convenience and Necessity as a Competing Telecommunications Service Provider
Docket No. 99-00122

Dear Mr. Waddell:

Enclosed please find an original and thirteen (13) copies of two late-filed exhibits in the above-referenced proceeding. These exhibits provide information requested by the Directors at ACI Corp.'s April 27, 199 hearing. Specifically, the first exhibit contains the financial statements portion from Rhythms NetConnections, Inc.'s ("Rhythms") March 31, 1999 Form 10-K filing with the Securities and Exchange Commission. The second exhibit is a copy of a press release dated April 29, 1998 submitted to clarify confusion at the hearing as to whether a particular debt offering occurred before or after Rhythms' Form 10-Q filing for the period ending September 30, 1998. I apologize for the delay in getting these late-filed exhibits to the Authority.

If you have any questions concerning this filing or the enclosed materials, please contact me.

Very truly yours,

BOULT, CUMMINGS, CONNERS & BERRY, PLC

Michael B. Bressman

Enclosures

cc: Colin Alberts (w/ enclosures)

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100464-000 05/11/1999

# SECURITIES AND EXCHANGE COMMISSION

## WASHINGTON, D.C. 20549

# FORM 10-K

**(MARK ONE)**

**X ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE**
**--- ACT OF 1934**

**FOR THE YEAR ENDED DECEMBER 31, 1998**
**OR**

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

**FOR THE TRANSITION PERIOD FROM ________________ TO ________________**
**COMMISSION FILE NUMBER 333-59393**

# RHYTHMS NETCONNECTIONS INC.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **DELAWARE** | **33-0747515** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| **6933 SOUTH REVERE PARKWAY ENGLEWOOD, COLORADO** | **80112** |
| (Address of principal executive office) | (Zip Code) |

Registrant's telephone number, including area code: (303) 476-4200

**Securities registered pursuant to Section 12(b) of the Act: NONE**

**Securities registered pursuant to Section 12(g) of the Act: NONE**

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

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

Aggregate market value of the voting stock held by non-affiliates of the registrant, computed using $16.00 for the Company's common stock on March 26, 1999: $23,522,816.*

Indicate the number of shares outstanding of the registrant's common stock as of the latest practicable date:

| Class | Outstanding at March 26, 1999 |
|---|---|
| Common Stock, $.001 par value | 9,643,660 |

DOCUMENTS INCORPORATED BY REFERENCE

Certain Exhibits filed with the Registrant's Registration Statement on Form S-1 (No. 333-72409), as amended, and Registrant's Registration Statement on Form S-4 (No. 333-59393), as amended, are incorporated herein by reference into Part IV of this Report.

* Excludes 8,173,484 shares of Common Stock held by executive officers, directors and stockholders whose ownership exceeds 5% of the Common Stock outstanding at March 26, 1999. Exclusion of such shares should not be construed to indicate that any such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the Registrant or that such person is controlled by or under common control with the Registrant.

## RHYTHMS NETCONNECTIONS INC.
## INDEX TO FINANCIAL STATEMENTS

## REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders of Rhythms NetConnections Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of cash flows, and of stockholders' equity present fairly, in all material respects, the financial position of Rhythms NetConnections Inc. and subsidiaries at December 31, 1997 and 1998, and the results of their operations and their cash flows for the period from February 27, 1997 (inception) through December 31, 1997 and for the year ended December 31, 1998 in conformity with generally accepted accounting principles. 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 generally accepted auditing standards 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.

**PRICEWATERHOUSECOOPERS LLP**

Denver, Colorado
March 4, 1999, except for the last paragraph of Note 11 as to which the date is March 19, 1999

## RHYTHMS NETCONNECTIONS INC.

## CONSOLIDATED BALANCE SHEETS

| | DECEMBER 31, 1997 | DECEMBER 31, 1998 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $10,166,000 | $21,315,000 |
| Short-term investments | -- | 115,497,000 |
| Accounts, loans and other receivables, net | -- | 2,376,000 |
| Inventory | -- | 340,000 |
| Prepaid expenses and other current assets | 95,000 | 230,000 |
| Total current assets | 10,261,000 | 139,758,000 |
| Equipment and furniture, net | 1,621,000 | 11,510,000 |
| Collocation fees, net | 327,000 | 13,804,000 |
| Deferred debt issue costs, net | -- | 6,304,000 |
| Other assets | 32,000 | 350,000 |
| | $12,241,000 | $171,726,000 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Current portion of long-term debt | $126,000 | $333,000 |
| Accounts payable | 951,000 | 10,601,000 |
| Accrued expenses and other current liabilities | 376,000 | 2,855,000 |
| Total current liabilities | 1,453,000 | 13,789,000 |
| Long-term debt | 442,000 | 472,000 |
| 13.5% senior discount notes, net | -- | 157,465,000 |
| Other liabilities | -- | 180,000 |
| Total liabilities | 1,895,000 | 171,906,000 |
| Commitments (note 10) | | |
| Mandatorily redeemable common stock warrants | -- | 6,567,000 |
| Stockholders' equity (deficit): | | |
| Series A convertible preferred stock, $0.001 par value; 17,000,000 shares authorized in 1997, 12,900,000 shares in 1998; 12,490,000 shares issued and outstanding in 1997, 12,855,094 shares in 1998 | 12,000 | 13,000 |
| Series B convertible preferred stock, $0.001 par value; no shares authorized in 1997, 4,044,943 shares in 1998; no shares issued and outstanding in 1997, 4,044,943 shares in 1998 | -- | 4,000 |
| Common stock, $0.001 par value; 54,635,294 shares authorized in 1997, 80,049,892 shares in 1998; 2,482,222 shares issued in 1997, 8,042,530 shares in 1998. | 2,000 | 8,000 |
| Treasury stock, at cost; 438,115 shares. | -- | (18,000) |
| Additional paid-in capital | 14,012,000 | 37,212,000 |
| Deferred compensation. | (1,258,000) | (5,210,000) |
| Accumulated deficit. | (2,422,000) | (38,756,000) |
| Total stockholders' equity (deficit) | 10,346,000 | (6,747,000) |
| | $12,241,000 | $171,726,000 |

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

## RHYTHMS NETCONNECTIONS INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

| | PERIOD FROM FEBRUARY 27, 1997 (INCEPTION) THROUGH DECEMBER 31, 1997 | YEAR ENDED DECEMBER 31, 1998 |
|---|---|---|
| Revenue: | | |
| Service and installation, net. | $-- | $528,000 |
| Operating Expenses: | | |
| Network and service costs. | -- | 4,695,000 |
| Selling and marketing. | 33,000 | 3,776,000 |
| General and administrative | 2,501,000 | 19,377,000 |
| Depreciation and amortization. | 1,000 | 1,081,000 |
| Total operating expenses | 2,535,000 | 28,929,000 |
| Loss from Operations | (2,535,000) | (28,401,000) |
| Other Income and Expense: | | |
| Interest income. | 114,000 | 5,813,000 |
| Interest expense (including amortized debt discount and issue costs) | (1,000) | (13,779,000) |
| Other. | -- | 33,000 |
| Net Loss | $(2,422,000) | $(36,334,000) |
| Net Loss Per Share: | | |
| Basic. | $(1.12) | $(12.18) |
| Diluted. | $(1.12) | $(12.18) |
| Shares Used in Computing Net Loss Per Share: | | |
| Basic. | 2,161,764 | 2,984,216 |
| Diluted. | 2,161,764 | 2,984,216 |

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

## RHYTHMS NETCONNECTIONS INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| | PERIOD FROM FEBRUARY 27, 1997 (INCEPTION) THROUGH DECEMBER 31, 1997 | YEAR ENDED DECEMBER 31, 1998 |
|---|---|---|
| Cash Flows from Operating Activities: | | |
| Net Loss. | $(2,422,000) | $(36,334,000) |
| Adjustments to reconcile net loss to net cash used for operating activities: | | |
| Depreciation of equipment and furniture | 1,000 | 454,000 |
| Amortization of collocation fees. | -- | 85,000 |
| Amortization of debt discount and deferred debt issue costs | -- | 13,882,000 |
| Amortization of deferred compensation | 192,000 | 725,000 |
| Compensation expense from stock option issued to employee | 73,000 | -- |
| Loss on sale of equipment to leasing company. | -- | 387,000 |
| Changes in assets and liabilities: | | |
| Increase in accounts, loans and other receivables, net. | -- | (2,376,000) |
| Increase in inventory | -- | (340,000) |
| Increase in prepaid expenses and other current assets | (95,000) | (135,000) |
| Increase in other assets. | (32,000) | (318,000) |
| Increase in accounts payable. | 388,000 | 2,287,000 |
| Increase in accrued expenses and other current liabilities. | 335,000 | 2,479,000 |
| Increase in other liabilities | -- | 180,000 |
| Net cash used for operating activities. | (1,560,000) | (19,024,000) |
| Cash Flows from Investing Activities: | | |
| Purchases of short-term investments | -- | (451,870,000) |
| Maturities of short-term investments. | -- | 336,373,000 |
| Purchases of equipment and furniture. | (1,018,000) | (9,973,000) |
| Payment of collocation fees | (327,000) | (13,562,000) |
| Net cash used for investing activities. | (1,345,000) | (139,032,000) |
| Cash Flows from Financing Activities: | | |
| Proceeds from leasing company for equipment | -- | 6,606,000 |
| Proceeds from issuance of 13.5% senior discount notes and warrants. | -- | 150,365,000 |
| Payment of debt issue costs on 13.5% senior discount notes. | -- | (6,519,000) |
| Proceeds from borrowings on long-term debt. | 568,000 | 432,000 |
| Repayments on long-term debt. | -- | (195,000) |
| Proceeds from issuance of common stock. | 13,000 | 242,000 |
| Proceeds from issuance of preferred stock | 12,490,000 | 18,292,000 |
| Purchase of treasury stock. | -- | (18,000) |
| Net cash provided by financing activities | 13,071,000 | 169,205,000 |
| Net increase in cash and cash equivalents | 10,166,000 | 11,149,000 |
| Cash and cash equivalents at beginning of period. | -- | 10,166,000 |
| Cash and cash equivalents at end of period. | $10,166,000 | $21,315,000 |
| Supplemental schedule of cash flow information: | | |
| Cash paid for interest. | $3,000 | $66,000 |
| Supplemental schedule of non-cash financing activities: | | |
| Equipment purchases payable, to be financed through operating leases. | $604,000 | $-- |
| Equipment and furniture purchases payable | $-- | $7,363,000 |

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

# RHYTHMS NETCONNECTIONS INC.
# CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

| | SERIES A CONVERTIBLE PREFERRED STOCK $0.001 PAR VALUE | | SERIES B CONVERTIBLE PREFERRED STOCK $0.001 PAR VALUE | | COMMON STOCK $0.001 PAR VALUE | |
|---|---|---|---|---|---|---|
| | # SHARES | AMOUNT | # SHARES | AMOUNT | # SHARES | AMOUNT |
| Issuance of common stock to Founders (at inception) | -- | $-- | -- | $-- | 2,161,764 | $2,000 |
| Issuance of Series A preferred stock for cash ($1.00 per share) | 12,490,000 | 12,000 | -- | -- | -- | -- |
| Issuance of common stock upon exercise of options ($0.04 per share exercise price) | -- | -- | -- | -- | 320,458 | -- |
| Grant of options to purchase Series A preferred stock ($0.80 per share exercise price). | -- | -- | -- | -- | -- | -- |
| Deferred compensation from grants of options to purchase common stock | -- | -- | -- | -- | -- | -- |
| Amortization of deferred compensation. | -- | -- | -- | -- | -- | -- |
| Net loss for 1997. | -- | -- | -- | -- | -- | -- |
| Balance at December 31, 1997 | 12,490,000 | 12,000 | -- | -- | 2,482,222 | 2,000 |
| Issuance of Series A preferred stock for cash ($0.80 per share) | 365,094 | 1,000 | -- | -- | -- | -- |
| Issuance of Series B preferred stock for cash ($4.45 per share) | -- | -- | 4,044,943 | 4,000 | -- | -- |
| Issuance of common stock upon exercise of options ($0.04 to $0.25 per share exercise price). | -- | -- | -- | -- | 5,560,308 | 6,000 |
| Purchase of treasury stock for cash ($0.04 per share). | -- | -- | -- | -- | -- | -- |
| Deferred compensation from grants of options to purchase common stock | -- | -- | -- | -- | -- | -- |
| Amortization of deferred compensation. | -- | -- | -- | -- | -- | -- |
| Reversal of deferred compensation from cancellation of grants to purchase common stock | -- | -- | -- | -- | -- | -- |
| Net loss for 1998. | -- | -- | -- | -- | -- | -- |
| Balance at December 31, 1998 | 12,855,094 | $13,000 | 4,044,943 | $4,000 | 8,042,530 | $8,000 |

| | TREASURY STOCK AT COST | | ADDITIONAL PAID-IN CAPITAL | DEFERRED COMPENSATION | ACCUMULATED DEFICIT | TOTAL STOCKHOLDERS' EQUITY (DEFICIT) |
|---|---|---|---|---|---|---|
| | # SHARES | AMOUNT | | | | |
| Issuance of common stock to Founders (at inception) | -- | $-- | $-- | $-- | $-- | $2,000 |
| Issuance of Series A preferred stock for cash ($1.00 per share) | -- | -- | 12,477,000 | -- | -- | 12,489,000 |
| Issuance of common stock upon exercise of options ($0.04 per share exercise price) | -- | -- | 12,000 | -- | -- | 12,000 |
| Grant of options to purchase Series A preferred stock ($0.80 per share exercise price). | -- | -- | 73,000 | -- | -- | 73,000 |
| Deferred compensation from grants of options to purchase common stock | -- | -- | 1,450,000 | (1,450,000) | -- | -- |
| Amortization of deferred compensation. | -- | -- | -- | 192,000 | -- | 192,000 |
| Net loss for 1997. | -- | -- | -- | -- | (2,422,000) | (2,422,000) |
| Balance at December 31, 1997 | -- | -- | 14,012,000 | (1,258,000) | (2,422,000) | 10,346,000 |
| Issuance of Series A preferred stock for cash ($0.80 per share) | -- | -- | 291,000 | -- | -- | 292,000 |
| Issuance of Series B preferred stock for cash ($4.45 per share) | -- | -- | 17,996,000 | -- | -- | 18,000,000 |
| Issuance of common stock upon exercise of options ($0.04 to $0.25 per share exercise price). | -- | -- | 236,000 | -- | -- | 242,000 |
| Purchase of treasury stock for cash ($0.04 per share). | 438,115 | (18,000) | -- | -- | -- | (18,000) |
| Deferred compensation from grants of options to purchase common stock | -- | -- | 4,908,000 | (4,908,000) | -- | -- |
| Amortization of deferred compensation. | -- | -- | -- | 725,000 | -- | 725,000 |
| Reversal of deferred compensation from cancellation of grants to purchase common stock | -- | -- | (231,000) | 231,000 | -- | -- |
| Net loss for 1998. | -- | -- | -- | -- | (36,334,000) | (36,334,000) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Balance at December 31, 1998 .................................... | 438,115 | $(18,000) | $37,212,000 | $(5,210,000) | $(38,756,000) | $(6,747,000) |

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

## NOTE 1--THE COMPANY

Rhythms NetConnections Inc. (the "Company"), a Delaware corporation, was organized under the name Accelerated Connections Inc. effective February 27, 1997. The Company's name was changed to Rhythms NetConnections Inc. as of August 15, 1997. The Company is in the business of providing high-speed data communications services on an end-to end basis to business customers and end users. The Company began service trials in the San Diego, California, market in December 1997 and began commercial operations in San Diego effective April 1, 1998.

The Company's ultimate success depends upon, among other factors, rapidly expanding the geographic coverage of its network services; entering into interconnection agreements with incumbent local exchange carriers, some of which are competitors or potential competitors of the Company; deploying network infrastructure; attracting and retaining customers; accurately assessing potential markets; continuing to develop and integrate its operational support system and other back office systems; obtaining any required governmental authorizations; responding to competitive developments; continuing to attract, retain and motivate qualified personnel; and continuing to upgrade its technologies and commercialize its network services incorporating such technologies. There can be no assurance that the Company will be successful in addressing these matters and failure to do so could have a material adverse effect on the Company's business, prospects, operating results and financial condition. As the Company continues the development of its business, it will seek additional sources of financing to fund its development. If unsuccessful in obtaining such financing, the Company will continue expansion of its operations on a reduced scale based on its existing capital resources.

## NOTE 2--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

PRINCIPLES OF CONSOLIDATION: The accompanying consolidated financial statements include the transactions and balances of Rhythms NetConnections Inc. and its wholly owned subsidiaries ACI Corp. and ACI Corp.--Virginia (since February 1998). All material intercompany transactions and balances have been eliminated.

USE OF ESTIMATES: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the financial statement date, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

REVENUE RECOGNITION: Revenue is recorded in the period services are provided to customers.

CASH AND CASH EQUIVALENTS: Cash and cash equivalents include cash on hand, money market funds, certificates of deposit, obligations of the U.S. Government and its agencies and commercial paper with a maturity of 90 days or less at the time of purchase.

SHORT-TERM INVESTMENTS. Short-term investments consist of obligations of the U.S. Government and its agencies and commercial paper that have an original maturity between 91 days and one year from the date of purchase. Management determines the appropriate classification of marketable debt and equity securities at the time of purchase and reevaluates such designation as of each balance sheet date.

FAIR VALUE OF FINANCIAL INSTRUMENTS: The carrying amounts of the Company's financial instruments as presented are reasonable estimates of those instruments' fair values because of the short maturity of

**NOTE 2--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

those instruments or based on the current rates offered to the Company for debt of the same remaining maturities.

INVENTORY: Inventory consists of communications equipment that will be installed at customer locations. Inventory is accounted for on a FIFO basis at the lower of cost or market.

EQUIPMENT AND FURNITURE: Equipment and furniture consists of purchased equipment, furniture, computer software, and leasehold improvements. Equipment and furniture is recorded at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, generally three to seven years or the lease term if shorter. When equipment and furniture is retired, sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and gains and losses resulting from such transactions are reflected in operations.

COLLOCATION FEES: Collocation fees represent nonrecurring fees paid to secure Central Office space for location of certain Company equipment. The fees are amortized over their estimated useful lives of ten years.

IMPAIRMENT OF LONG-LIVED ASSETS: The Company investigates potential impairments of their long-lived assets on an exception basis when evidence exists that events or changes in circumstances may have made recovery of an asset's carrying value unlikely. An impairment loss is recognized when the sum of the expected undiscounted future net cash flows is less than the carrying amount of the asset. No such losses have been identified.

CONCENTRATIONS OF CREDIT RISK: Credit risk is primarily concentrated in cash equivalents and short-term investments. Cash in excess of operating requirements is conservatively invested in money market funds, certificates of deposit with high-quality financial institutions, obligations of the U.S. Government and its agencies and commercial paper rated A-1, P-1 to minimize risk.

Two customers comprise 14.9 percent and 7.5 percent of the Company's net trade receivable balance at December 31, 1998 and 36.7 percent and 13.7 percent of revenues for the year ended December 31, 1998.

INCOME TAXES: The Company provides for income taxes utilizing the liability method. Under the liability method, current income tax expense or benefit represents income taxes expected to be payable or refundable for the current period. Deferred income tax assets and liabilities are established for both the impact of differences between the financial reporting bases and tax bases of assets and liabilities and for the expected future tax benefit to be derived from tax credits and tax loss carryforwards. Deferred income tax expense or benefit represents the change during the reporting period in the net deferred income tax assets and liabilities. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

NET LOSS PER SHARE: The Company has adopted Statement of Financial Accounting Standard ("SFAS") No. 128, "Earnings Per Share." Basic earnings per share ("EPS") is calculated by dividing the income or loss available to common stockholders by the weighted average number of common shares outstanding for the period, without consideration for common stock equivalents. Diluted EPS is computed by dividing the income or loss available to common stockholders by the weighted average number of common shares outstanding for the period in addition to the weighted average number of

**NOTE 2--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

common stock equivalents outstanding for the period. Shares subject to repurchase by the Company are considered common stock equivalents for purposes of this calculation. Shares issuable upon conversion of the Series A and Series B preferred stock, upon the exercise of outstanding stock options and warrants and shares issued subject to repurchase by the Company totaling 36,653,940 and 52,958,513 at December 31, 1997 and 1998, respectively, have been excluded from the computation since their effect would be antidilutive.

STOCK-BASED COMPENSATION: The Company measures compensation expense for their employee stock-based compensation using the intrinsic value method and provides pro forma disclosures of net loss as if the fair value method had been applied in measuring compensation expense. Under the intrinsic value method of accounting for stock-based compensation, when the exercise price of options granted to employees is less than the fair value of the underlying stock on the date of grant, compensation expense is to be recognized over the applicable vesting period.

NEW ACCOUNTING PRONOUNCEMENTS: In June 1998, SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," was issued. This statement establishes accounting and reporting standards for derivative instruments and for hedging activities. The Company will adopt SFAS No. 133 as required in 2000. The Company expects that adoption will have no impact on their consolidated financial statements.

RECLASSIFICATIONS: Certain 1997 balances have been reclassified to conform to the 1998 presentation.

**NOTE 3--SHORT-TERM INVESTMENTS**

The Company's marketable debt securities are classified as held-to-maturity and carried at amortized cost, which approximates fair value. Short-term investments consist of the following:

| | DECEMBER 31, 1997 | DECEMBER 31, 1998 |
|---|---|---|
| Commercial Paper. | $-- | $33,170,000 |
| U.S. Government Securities. | -- | 82,327,000 |
| | $-- | $115,497,000 |

## NOTE 4--COMPOSITION OF CERTAIN BALANCE SHEET COMPONENTS

| | DECEMBER 31, 1997 | DECEMBER 31, 1998 |
|---|---|---|
| Accounts, loans and other receivables, net: | | |
| Interest. | $-- | $2,135,000 |
| Trade, net of allowance for doubtful accounts of $50,000 in 1998 | -- | 197,000 |
| Employee expense advances and loans | -- | 44,000 |
| | $-- | $2,376,000 |
| Equipment and furniture, net: | | |
| Operating equipment | $1,241,000 | $9,633,000 |
| Office furniture. | 43,000 | 917,000 |
| Leasehold improvements. | 32,000 | 668,000 |
| Computer software | 173,000 | 456,000 |
| Computer equipment. | 133,000 | 274,000 |
| Lab equipment | -- | 17,000 |
| Accumulated depreciation. | (1,000) | (455,000) |
| | $1,621,000 | $11,510,000 |
| Accrued expenses and other current liabilities: | | |
| Accrued payroll | $217,000 | $1,524,000 |
| Carrier services and other operating costs. | -- | 991,000 |
| Other | 159,000 | 340,000 |
| | $376,000 | $2,855,000 |

## NOTE 5--DEBT

As of December 31, 1997 and 1998, the Company had a note payable of $568,000 and $805,000, respectively, to a financial institution. Terms of the note payable include an interest rate of prime plus 0.25 percent (8.75 percent and 8.0 percent at December 31, 1997 and 1998, respectively) payable monthly on the outstanding principal. The note is collateralized by assets of the Company and is to be amortized over a 36-month repayment period. The $805,000 will be repaid during the years 1999 through 2001 in the amounts of $333,000 each in 1999 and 2000 and $139,000 in 2001.

On May 5, 1998, the Company issued 13.5 percent senior discount notes due 2008 in the principal amount of $290,000,000 at maturity, combined with warrants to purchase 4,732,800 shares of common stock. The notes were issued at a discount; cash proceeds from the issuance of the notes and warrants were $150,365,000. The Company additionally incurred approximately $6,519,000 in debt issue costs. The notes will accrete in value through May 15, 2003 at a rate of 13.5 percent per annum, compounded semi-annually; no cash interest will be payable prior to that date. Upon a change in control or upon certain asset sales, the Company must offer to repurchase all or a portion of the outstanding notes. In addition, the Company has the option to repurchase the notes upon payment of a premium of accreted value at that point in time. The notes contain covenants that restrict the Company's ability to make certain payments, including dividend payments, and incur additional debt.

**NOTE 5--DEBT (CONTINUED)**

The warrants issued in connection with the senior discount notes are exercisable at a price of $0.004 per share. The warrants expire May 15, 2008. The warrants may be required to be repurchased by the Company for cash upon the occurrence of a repurchase event, such as a consolidation, merger, or sale of assets to another entity, as defined in the provisions of the Warrant Agreement, at a price to be determined by an independent financial expert selected by the Company. In the event a repurchase event occurs, the difference between the repurchase price and the carrying value of the warrants would be charged to equity. The value ascribed to the warrants of $6,567,000 resulted in additional debt discount, which, together with the debt issue costs are being amortized to interest expense using the effective interest method over the period that the notes are outstanding.

Effective November 20, 1998, the Company completed an exchange offer of the 13.5 percent senior discount notes that allowed for registration of such notes under the Securities Act of 1933, as amended. $289,000,000 of the original issue notes were tendered for exchange. The registered notes have substantially the same terms and conditions as the unregistered notes, except that the registered notes are not subject to the restrictions on resale or transfer that applied to the unregistered notes.

During May 1998 the Company entered into a 36-month lease line that provides for $24.5 million in equipment on an operating lease basis. In connection with this lease agreement, the Company issued 574,380 warrants to purchase common stock at a price of $1.85 per share, exercisable immediately.

**NOTE 6--STOCKHOLDERS' EQUITY**

The Company was initially capitalized in February 1997 with common stock. In July 1997, the Company was granted authority to issue two classes of stock consisting of up to 17,000,000 shares of Series A preferred stock and 54,635,294 shares of common stock, as adjusted for the November 1998 and March 1999 stock splits, both with a $0.001 par value per share.

Effective March 6, 1998, the Company amended its Certificate of Incorporation to increase the number of authorized common shares to 54,983,160, as adjusted for the November 1998 and March 1999 stock splits, to decrease the number of authorized preferred shares to 16,944,943, and to designate 12,900,000 of the preferred shares as Series A and 4,044,943 shares as Series B.

Effective April 28, 1998, the Company amended its Certificate of Incorporation to increase the number of authorized common shares to 59,715,960, as adjusted for the November 1998 and March 1999 stock splits.

Effective November 4, 1998, the Company completed a two-for-one split of its common stock. The accompanying consolidated financial statements have been restated for all periods presented to reflect the stock split.

The Company's Series A and Series B preferred stock may be converted, at the option of the holder, into the Company's common stock on a 2.4 to 1 basis, subject to antidilution protection on a broad-based weighted-average basis. The preferred stock will also be automatically converted upon certain closings of registered public offerings of common stock. The holders of the Series A preferred stock are entitled to receive non-cumulative dividends in the amount equal to $0.08 per share per annum and the holders of the Series B preferred stock are entitled to receive non-cumulative dividends of $0.356 per share per annum, as and if declared by the Board of Directors, or an amount equal to that paid on any other outstanding shares of the Company, payable quarterly, as and if declared by the Board of Directors. In the event of a liquidation of the Company, the holders of the Series A and

## NOTE 6--STOCKHOLDERS' EQUITY (CONTINUED)

Series B preferred stock will be entitled, in preference to the holders of common stock, to an amount equal to $1.00 per share and $4.45 per share, respectively, plus all declared and unpaid dividends. The preferred shares entitle holders to two votes per share, on an "as-converted" basis.

## NOTE 7--STOCK OPTIONS

The Company has established the 1997 Stock Option/Stock Issuance Plan (the "Plan"), which provides for the grant of options to employees, directors and outside consultants for purchase of up to an aggregate of 11,673,530 shares of common stock. The options are immediately exercisable and expire within ten years after the date of grant. Shares acquired upon exercise are subject to repurchase by the Company ratably over a four-year period from the date of grant, at the option of the Company and at the exercise price. The Plan provides for both incentive option and non-statutory option grants and for accelerated vesting in the event of a 50 percent or more change in control of the Company.

Plan activity is as follows:

| | NUMBER OF SHARES | WEIGHTED AVERAGE FAIR VALUE | WEIGHTED AVERAGE EXERCISE PRICE |
|---|---|---|---|
| Granted. | 5,801,714 | $0.29 | $0.04 |
| Exercised. | (320,458) | $0.29 | $0.04 |
| Outstanding at December 31, 1997 | 5,481,256 | $0.29 | $0.04 |
| Granted. | 3,364,680 | $2.62 | $0.84 |
| Exercised. | (5,560,308) | $0.30 | $0.04 |
| Canceled | (136,348) | $1.10 | $0.22 |
| Outstanding at December 31, 1998 | 3,149,280 | $2.73 | $0.89 |

The following summarizes the outstanding and exercisable options under the Plan at December 31, 1998:

| EXERCISE PRICE | NUMBER OUTSTANDING | WEIGHTED AVERAGE REMAINING LIFE | WEIGHTED AVERAGE EXERCISE PRICE | NUMBER EXERCISABLE | WEIGHTED AVERAGE EXERCISE PRICE |
|---|---|---|---|---|---|
| | OPTIONS OUTSTANDING | | | OPTIONS EXERCISABLE | |
| $0.04 | 177,480 | 9.03 years | $0.04 | 177,480 | $0.04 |
| $0.21 to $0.25 | 1,591,680 | 9.42 years | $0.23 | 1,591,680 | $0.23 |
| $1.67 to $1.88 | 1,380,120 | 9.83 years | $1.75 | 1,380,120 | $1.75 |

During 1997 and 1998, all options were granted to employees at less than fair value on the date of grant, resulting in $1,450,000 and $4,908,000, respectively, of deferred compensation recorded as a reduction of stockholders' equity. These amounts are being amortized as a charge to general and administrative expenses over the vesting periods of the applicable options; such amortization totaled $192,000 and $725,000 for the periods ended December 31, 1997 and 1998, respectively.

An option to purchase 365,094 shares of Series A Preferred Stock at $0.80 per share was granted to an employee during 1997. The Company recorded $73,000 in compensation expense during 1997 related to this grant.

## NOTE 7--STOCK OPTIONS (CONTINUED)

Had compensation expense for the Company's Plan and the Preferred Stock option been determined based on the fair value method of accounting for stock-based compensation, the Company's net loss and net loss per share for the periods ended December 31, 1997 and 1998 would have been increased by $11,000 and $60,000 and $0.01 and $0.02 per share, respectively. For purposes of determining this compensation expense, the fair value of each option grant is estimated on the grant date using the Black Scholes option pricing model with the following weighted average assumptions used for grants during the periods ended December 31, 1997 and 1998, respectively: no dividend yield, risk free interest rates of 5.3 percent and 4.9 percent, respectively, expected volatility of nil, and expected term of four years for common options and six months for the preferred option.

## NOTE 8--INCOME TAXES

As of December 31, 1998, the Company had net operating loss carryforwards of approximately $37,000,000, which are available to offset future taxable income through 2018 for federal taxes and 2005 for state taxes, subject to the limitations of Internal Revenue Code Section 382 relating to changes in ownership of the Company. The deferred tax asset arising from the loss carryforwards has been fully offset by a valuation allowance since it is more likely than not that it will not be realized. The valuation allowance increased by $13,905,000 during 1998, primarily as a result of the additional losses in 1998.

Components of deferred income taxes are as follows:

| | DECEMBER 31, 1997 | DECEMBER 31, 1998 |
|---|---|---|
| Deferred tax assets: | | |
| Net operating loss carryforwards. | $908,000 | $14,724,000 |
| Accrued vacation and other. | 89,000 | 178,000 |
| Gross deferred tax asset. | 997,000 | 14,902,000 |
| Valuation allowance | (997,000) | (14,902,000) |
| Net deferred income taxes | $-- | $-- |

The provision for (benefit from) income taxes reconciles to the statutory federal tax rate as follows:

| | DECEMBER 31, 1997 | DECEMBER 31, 1998 |
|---|---|---|
| Statutory federal tax rate. | (34.0)% | (34.0)% |
| State income tax, net of federal benefit. | (5.4) | (5.4) |
| Other | (1.8) | 0.9 |
| Deferred tax asset valuation allowance. | 41.2 | 38.5 |
| | --% | --% |

## NOTE 9--RELATED PARTY TRANSACTIONS

The Company's in-house counsel is also a partner in a law firm used externally by the Company. During 1997 and 1998, the Company incurred legal fees and expenses of approximately $92,000 and

## NOTE 9--RELATED PARTY TRANSACTIONS (CONTINUED)

$1,269,000, respectively, to the external firm, in addition to the salary paid to the in-house counsel. At December 31, 1998, the Company had a balance payable of $372,000 to this entity.

Two members of the Company's Board of Directors serve as directors to a company that supplies equipment to the Company. The total purchases during 1997 and 1998 from the equipment supplier were approximately $419,000 and $13,005,000, respectively. At December 31, 1998, the Company had a balance payable of $2,451,000 to this entity.

## NOTE 10--COMMITMENTS

The Company leases office space and certain office equipment under non-cancelable operating lease agreements. The leases range in term from 24 months to 60 months and, in certain instances, provide for options to extend. Rent expense under the operating leases for 1997 and 1998 totaled $46,000 and $2,044,000, respectively. Future minimum rental payments under the leases are $11,169,000 in 1999, $11,251,000 in 2000, $9,667,000 in 2001, $1,710,000 in 2002, and $1,190,000 in 2003.

## NOTE 11--SUBSEQUENT EVENTS

Effective March 2, 1999, the Company amended its Certificate of Incorporation to increase the number of authorized common shares to 84,527,584, as adjusted for the November 1998 and March 1999 stock splits, and to authorize 3,731,410 shares of Series C Preferred Stock.

Effective March 4, 1999, the Company issued 3,731,410 shares of its Series C preferred stock to MCI WorldCom's investment fund at a price of $8.04 per share for total proceeds to the Company of $30,000,000. In connection with this investment, MCI WorldCom also received warrants to purchase up to 720,000 shares of common stock at a price of $6.70 per share. The terms of the transaction also provide for the Company and MCI WorldCom to enter into various business relationships, including MCI WorldCom's commitment to sell 100,000 of the Company's DSL lines over a period of five years, subject to penalties for failure to reach target commitments.

During January and February 1999, the Company granted options to purchase 1,615,686 shares of common stock pursuant to the Plan. The grant of these options will result in additional deferred compensation in 1999 and compensation expense in 1999 and future years as the options vest.

On March 19, 1999, the Company completed a six for five split of its common stock. The accompanying consolidated financial statements have been restated for all periods presented to reflect the stock split.

## NOTE 12--SUBSEQUENT EVENTS (UNAUDITED)

On March 16, 1999, the Company issued 3,731,409 shares of its Series C Preferred Stock to Microsoft at a price of $8.04 per share for total proceeds to the Company of $30,000,000. In connection with this investment, Microsoft also received warrants to purchase up to 720,000 shares of common stock at a price of $6.70 per share. The terms of the transaction also provide for the Company and Microsoft to enter into various business relationships.

The Company has filed a registration statement for a public offering of approximately 9,375,000 shares of common stock.

## NOTE 12--SUBSEQUENT EVENTS (UNAUDITED) (CONTINUED)

On March 16, 1999, the Company's Board of Directors approved the 1999 Stock Incentive Plan and the 1999 Employee Stock Purchase Plan, subject to stockholder approval. The 1999 Stock Incentive Plan is intended to serve as the successor equity incentive program to the 1997 Stock Option/Stock Issuance Plan. An initial reserve of 7,440,000 shares of common stock has been authorized for issuance under the 1999 Stock Incentive Plan. The Company has also initially reserved an additional 1,200,000 shares of common stock for the 1999 Employee Stock Purchase Plan. The 1999 Stock Incentive Plan will become effective upon the effectiveness of the public offering. The 1999 Employee Stock Purchase Plan will become effective upon the execution of an Underwriting Agreement for the public offering.

## EXHIBIT 23.1

## CONSENT OF INDEPENDENT ACCOUNTANTS

We consent to the incorporation by reference in the registration statement of Rhythms NetConnections Inc. on Form S-8 of our report dated March 4, 1999, except for the last paragraph of Note 11 as to which the date is March 19, 1999, on our audits of the consolidated financial statements of Rhythms NetConnections Inc. as of December 31, 1997 and 1998 and for the period from February 27, 1997 (inception) to December 31, 1997 and the year ended December 31, 1998, which report is included in this Annual Report on Form 10-K

PricewaterhouseCoopers LLP

Denver, Colorado
March 30, 1999

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**THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM DECEMBER 31, 1998 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.**
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PRESS releases

Leadership Team
Financial Backing
Capabilities
Technical Alliances
Press Releases
Quick Facts
Employment
back

## Rhythms NetConnections Completes $150 Million Private Debt Financing, $10 Million Equity Placement from Enron Corporation

*Infusion of capital to fund expansion nationwide; Rhythms adds new CFO to leadership team*

Englewood, CO (April 29, 1998)

Rhythms NetConnections, the high-performance networking company, recently announced completion of a $150 million debt round. This financing comes in addition to new equity investment received in March, 1998, from Enron Corporation, the nation's largest private energy company. The new sources of capital funding bring total debt and equity funding to over $180 million, and will be used to fund network deployment, technical staffing and support systems for Rhythms' expansion to new markets.

Initial venture capital backing for Rhythms' start-up, staffing and launch include Kleiner Perkins Caufield & Byers, Brentwood Partners, The Sprout Group and Enterprise Partners.

Rhythms also announced appointment of Scott C. Chandler, as its Chief Financial Officer. Mr. Chandler previously served as President and Chief Executive Officer of C-COR Electronics, a pioneer in the cable television industry and leading supplier of broadband telecommunications equipment. During Mr. Chandler's tenure, C-COR emerged as one of the leaders in the broadband industry. Mr. Chandler will be based at company headquarters.

### About Rhythms NetConnections

Rhythms NetConnections is an Englewood, Colorado-based national network provider, with West Coast headquarters in San Diego and sales offices in San Francisco and Los Angeles. Its services include high-performance networking solutions like Power Internet access, MetroLAN enterprise networks, legacy network integration and enterprise telework solutions. Rhythms distributes its capabilities through market leading network integrators and Internet Service Providers. Telecommunication services for Rhythms are provided by ACI, a wholly-owned subsidiary of Rhythms. For more information regarding Rhythms NetConnections, call 1-800-RHYTHMS.

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