



ORIGINAL

210 N. Park Ave.
Winter Park, FL
32789

February 6, 2003
Via Overnight Delivery

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

Blanca Bayo, Director
Division of the Commission Clerk & Administrative Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0870

030143-TI

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

RE: **DIECA Communications, Inc. d/b/a Covad Communications Company**
Application for authority to provide Interexchange Telecommunications Service within the State of Florida

Dear Ms. Bayo:

Enclosed for filing are the original and six (6) copies of the above-referenced application of DIECA Communications, Inc. d/b/a Covad Communications Company.

Also enclosed is a \$250 check to cover the filing fee.

Please acknowledge receipt of this filing by returning, filed stamped, the extra copy of this letter in the self-addressed stamped envelope.

I may be reached at 407-740-8575 or via email at mbyrnes@tminc.com with any questions, comments or correspondence regarding this application. Thank you for your assistance.

Sincerely,

Monique Byrnes
Consultant to DIECA Communications, Inc.
d/b/a Covad Communications Company

Check received with filing and forwarded to Fiscal for deposit. Fiscal to forward deposit information to Records.

Initials of person who forwarded check:

cc: G. Hyde, Covad
file: Covad - FL-IXC
tms: fli0300

03 FEB 10 AM 9:47

RECEIVED & FILED

R-V-N

FPSC-BUREAU OF RECORDS

DISTRIBUTION CENTER

DOCUMENT NUMBER - DATE

01350 FEB 10 8

FPSC-COMMISSION CLERK

FLORIDA PUBLIC SERVICE COMMISSION

**DIVISION OF REGULATORY OVERSIGHT
CERTIFICATION SECTION**

**APPLICATION FORM FOR AUTHORITY TO PROVIDE
INTEREXCHANGE TELECOMMUNICATIONS SERVICE
BETWEEN POINTS WITHIN THE STATE OF FLORIDA**

Instructions

- ◆ This form is used as an original application for an original certificate and for approval of assignment or transfer of an existing certificate. In case of an assignment or transfer, the information provided shall be for the assignee or transferee (See Page 16).
- ◆ Print or Type all responses to each item requested in the application and appendices. If an item is not applicable, please explain why.
- ◆ Use a separate sheet for each answer which will not fit the allotted space.
- ◆ Once completed, submit the original and six (6) copies of this form along with a non-refundable application fee of **\$250.00** to:

**Florida Public Service Commission
Division of Records and Reporting
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850
(850) 413-6770**

- ◆ If you have questions about completing the form, contact:

**Florida Public Service Commission
Division of Regulatory Oversight
Certification Section
2540 Shumard Oak Blvd.
Tallahassee, Florida 32399-0850
(850) 413-6600**

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

X **Original certificate** (new company)

Approval of transfer of existing certificate: Example, a non-certificated company purchases an existing company and desires to retain the certificate of authority of that company.

Approval of assignment of existing certificate: Example, a certificated company purchases an existing company and desires to retain the certificate of authority of that company.

Approval of transfer of control: Example, a company purchases 51% of a certificated company. The Commission must approve a new controlling entity.

2. Name of Company:

DIECA Communications, Inc.

3. Name under which applicant will do business (fictitious name, etc.):

Covad Communications Company

4. Official mailing address (including street name & number, post office box, city, state, zip code):

Covad Communications Company
3420 Central Expressway
Santa Clara, CA 95051

5. Florida address (including street name & number, post office box, city, state, zip code):

Applicant has no regulatory office in Florida.

Covad's regional regulatory office is:
1230 Peachtree Street, NE, 19th Floor
Atlanta, GA 30309

6. **Select type of business your company will be conducting. \sqrt (check all that apply):**

X **Facilities based carrier** - company owns and operates or plans to own and operate telecommunications switches and transmission facilities in Florida.

Operator Service Provider - company provides or plans to provide alternative operator services for IXCs; or toll operator services to call aggregator locations; or clearinghouse services to bill such calls.

X **Reseller** - company has or plans to have one or more switches but primarily leases the transmission facilities of other carriers. Bills its own customer base for services used.

X **Switchless Rebiller** - company has no switch or transmission facilities but may have a billing computer. Aggregates traffic to obtain bulk discounts from underlying carrier. Rebills end users at a rate above its discount but generally below the rate end users would pay for unaggregated traffic.

Multi-Location Discount Aggregator - company contracts with unaffiliated entities to obtain bulk/volume discounts under multi-location discount plans from certain underlying carriers. Then offers the resold service by enrolling unaffiliated customers.

Prepaid Debit Card Provider - any person or entity that purchases 800 access from an underlying carrier or unaffiliated entity for use with prepaid debit card service and/or encodes the cards with personal identification numbers.

7. **Structure of organization:**

	Individual	Corporation
X	Foreign Corporation	Foreign Partnership
	General Partnership	Limited Partnership
	Other	

8. **If individual, provide:**

Name: Not applicable
Title:
Address:
City, ST, Zip:
Telephone #:
Fax #:
Internet E-Mail Address:
Internet Website Address:

9. **If incorporated in Florida, provide proof of authority to operate in Florida:**

Not applicable

10. **If foreign corporation, provide proof of authority to operate in Florida:**

Florida Secretary of State Corporate Registration #: F98000002704

11. **If using fictitious name-d/b/a, provide proof of compliance with fictitious name statute (Chapter 865.09,FS) to operate in Florida:**

Florida Secretary of State fictitious name registration #: G99102900091

12. **If a limited liability partnership, provide proof of registration to operate in Florida:**

Florida Secretary of State registration #: Not applicable

13. **If a partnership, provide name, title and address of all partners and a copy of the partnership agreement.**

Name:

Title:

Address:

City, ST, Zip:

Telephone #:

Fax #:

Internet E-Mail Address:

Internet Website Address:

14. **If a foreign limited partnership, provide proof of compliance with the foreign limited partnership statute (Chapter 620.169,FS), if applicable.**

Florida registration #: Not applicable

15. **Provide F.E.I. Number (if applicable):** 94-3255151

16. Provide the following (if applicable):

(a) Will the name of your company appear on the bill for your services?
X Yes No

(b) If not, who will bill for your services?

Name:
Title:
Address:
City, ST, Zip:
Telephone #:
Fax #:
Internet E-Mail Address:
Internet Website Address:

(c) How is this information provided?

Not applicable

17. Who will receive the bills for your service?

Residential customers	Business customers X
PATS providers	PATS station end-users
Hotels & motels	Hotel & motel guests
Universities	Universities dormitory residents
Other: Anyone who uses the Company's service	

18. Who will serve as liaison to the Commission with regard to the following:

(a) the application:

Monique Byrnes, Consultant
Consultant to Covad Communications Company
Technologies Management, Inc.
P.O. Drawer 200
Winter Park, Florida 32790-0200
Telephone: 407-740-8575
Fax: 407-740-0613
Email: mbyrnes@tminc.com

(b) Official point of contact for the ongoing operations of the company:

Jayna Bell
Senior Paralegal
Covad Communications Company
1230 Peachtree Street, N.E.
Atlanta, GA 30309
Telephone: 404-942-3491
Fax: 404-942-3495
Email: jbell@covad.com

(c) Complaints/Inquiries from customers:

John Romero Campbell
Executive Escalation
Covad Communications Company
7901 Lowry Blvd.
Denver, CO 80230
Telephone: 702-208-1503
Fax: 208-485-1574
Email: joromero@covad.com

19. List the states in which the applicant:

(a) has operated as an interexchange telecommunications company:

None to date. Applicant provides DSL Internet Access, an interstate service, throughout the country.

(b) has applications pending to be certificated as an interexchange telecommunications company:

Applicant has applications pending to be an interexchange telecommunications company in Pennsylvania and Georgia.

(c) is certificated to operate as an interexchange telecommunications company:

Alabama, Arizona, Connecticut, Colorado, Delaware, Idaho, Illinois, Indiana, Iowa, Kentucky, Maryland, Minnesota, Mississippi, Missouri, Montana, Nevada, New Jersey, New York, North Dakota, Ohio, Oklahoma, South Carolina, South Dakota, Utah, Virginia, Washington, Wisconsin, and Wyoming.

(d) has been denied authority to operate as an interexchange telecommunications company and the circumstances involved:

None

(e) has had regulatory penalties imposed for violations of telecommunications statutes and the circumstances involved:

None

(f) has been involved in civil court proceedings with an interexchange carrier, local exchange company or other telecommunications entity, and the circumstances involved:

Applicant has attached a list of all such cases to this application as Exhibit V.

20. Indicate if any of the officers, directors, or any of the ten largest stockholders have previously been:

- (a) adjudged bankrupt, mentally incompetent, or found guilty of any felony or of any crime, or whether such actions may result from pending proceedings. If so, please explain.**

Applicant is a wholly owned subsidiary of Covad Communications Group, Inc., a publicly traded corporation ("Covad"). In August 2001, Covad filed for protection pursuant to Chapter 11 of the United States Bankruptcy Court. On December 13, 2001, the United States Bankruptcy Court for the District of Delaware entered an Order confirming Covad's pre-negotiated First Amended Plan of Reorganization, as modified on November 21, 2001. No officer or director of Applicant has been adjudged bankrupt.

- (b) an officer, director partner or stockholder in any other Florida certificated telephone company. If yes, give name of company and relationship. If no longer associated with company, give reason why not.**

No.

21. The applicant will provide the following interexchange carrier services (check all that apply):

- A. **MTS with distance sensitive per minute rates**
 - Method of access is FGA
 - Method of access is FGB
 - Method of access is FGD
 - Method of access is 800

- B. **MTS with route specific rates per minute**
 - Method of access is FGA
 - Method of access is FGB
 - Method of access is FGD
 - Method of access is 800

- C. **MTS with statewide flat rates per minute (i.e. not distance sensitive)**
 - Method of access is FGA
 - Method of access is FGB
 - Method of access is FGD
 - Method of access is 800

- D. **MTS for pay telephone service providers.**

- E. **Block of time calling plan (Reach Out Florida, Ring America, etc.)**

- F. **800 Service (Toll free)**

- G. **WATS type service (Bulk or volume discount)**
 - Method of access is via dedicated facilities
 - Method of access is via switched facilities

- H. **Private line services (Channel Services) (For ex. 1.544 mbps, DS-3, etc.)**

- I. **Travel service**
 - Method of access is 950
 - Method of access is 800

- J. **900 service**

- K. **Operator Services**
 - Available to presubscribed customers
 - Available to non presubscribed customers (for example, patrons of hotels, students in universities, patients in hospitals.
 - Available to inmates

Services included are:

 - Station assistance
 - Person to person assistance
 - Directory assistance
 - Operator verify and interrupt
 - Conference calling

22. **Submit the proposed tariff under which the company plans to begin operation. Use the format required by Commission Rule 25-24.485.(example enclosed).**

Applicant has attached a proposed interexchange tariff as Exhibit VI.

23. **Submit the following:**

- A. **Managerial capability:** give resumes of employees/officers of the company that would indicate sufficient managerial experiences of each.
- B. **Technical capability:** give resumes of employees/officers of the company that would indicate sufficient technical experiences or indicate what company has been contracted to conduct technical maintenance.
- C. **Financial capability.**

The application **should contain** the applicant's audited financial statements for the most recent 3 years. If the applicant does not have audited financial statements, it shall so be stated.

The unaudited financial statements should be signed by the applicant's chief executive officer and chief financial officer **affirming that the financial statements are true and correct** and should include:

1. the balance sheet;
2. income statement; and
3. statement of retained earnings.

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

Further, the following (which includes supporting documentation) should be provided:

1. **A written explanation** that the applicant has sufficient financial capability to provide the requested service in the geographic area proposed to be served.
2. **A written explanation** that the applicant has sufficient financial capability to maintain the requested service.
3. **A written explanation** that the applicant has sufficient financial capability to meet its lease or ownership obligations.

Applicant has attached as Exhibit III and IV explanations and information responsive to this request.

THIS PAGE MUST BE COMPLETED AND SIGNED

APPLICANT ACKNOWLEDGMENT STATEMENT

1. **REGULATORY ASSESSMENT FEE:**

I understand that all telephone companies must pay a regulatory assessment fee in the amount of .15 of one percent of its gross operating revenue derived from intrastate business. Regardless of the gross operating revenue of a company, a minimum annual assessment fee of \$50 is required.

2. **GROSS RECEIPTS TAX:**

I understand that all telephone companies must pay a gross receipts tax of two and one-half percent on all intra and interstate business.

3. **SALES TAX:**

I understand that a seven percent sales tax must be paid on intra and interstate revenues.

4. **APPLICATION FEE:**

A non-refundable application fee of \$250.00 must be submitted with the application.

UTILITY OFFICIAL:



Doug Carlen, Assistant Secretary
DIECA Communications, Inc.
3420 Central Expressway
Santa Clara, CA 95051
Telephone: 408-616-6618
Fax: 408-616-6614

1/13/03

Date

THIS PAGE MUST BE COMPLETED AND SIGNED

CUSTOMER DEPOSITS AND ADVANCE PAYMENTS

A statement of how the Commission can be assured of the security of the customer's deposits and advance payments may be provided in one of the following ways (applicant, please, check one):

- (X) The applicant will not collect deposits nor will it collect payments for service more than one month in advance.

- () The applicant intends to collect deposits and/or advance payments for more than one month's service and will file and maintain a surety bond with the Commission in an amount equal to the current balance of deposits and advance payment in excess of one month. (The bond must accompany the application).

UTILITY OFFICIAL:



Doug Carlen, Assistant Secretary
DIECA Communications, Inc.
3420 Central Expressway
Santa Clara, CA 95051
Telephone: 408-616-6618
Fax: 408-616-6614

1/13/03
Date

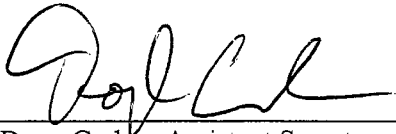
THIS PAGE MUST BE COMPLETED AND SIGNED

AFFIDAVIT

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

Further, I am aware that pursuant to Chapter 837.06, Florida Statutes, "Whoever knowingly makes a false statement in writing with the intent to mislead a public servant in the performance of his official duty shall be guilty of a misdemeanor of the second degree, punishable as provided in s. 775.082 and s. 775.083".

UTILITY OFFICIAL:



Doug Carlen, Assistant Secretary
DIECA Communications, Inc.
3420 Central Expressway
Santa Clara, CA 95051
Telephone: 408-616-6618
Fax: 408-616-6614

1/13/03
Date

CURRENT FLORIDA INTRASTATE SERVICES

Applicant **has** () or **has not** (X) previously provided intrastate telecommunications in Florida.

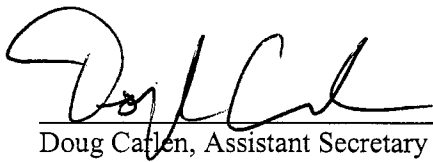
Note: Covad provides DSL-based service in Florida. DSL is a jurisdictionally interstate service.

If the answer is Has, fully describe the following:

- a) What services have been provided and when did these services begin?

- b) If the services are not currently offered, when were they discontinued?

UTILITY OFFICIAL:



Doug Catlen, Assistant Secretary
DIECA Communications, Inc.
3420 Central Expressway
Santa Clara, CA 95051
Telephone: 408-616-6618
Fax: 408-616-6614

1/13/03
Date _____

CERTIFICATE TRANSFER, OR ASSIGNMENT STATEMENT

I, _____ of _____, and current holder of Florida Public Service Commission Certificate Number # _____, have reviewed this application and join in the petitioner's request for a:

- Transfer
- Assignment

of the above mentioned certificate.

UTILITY OFFICIAL:

Name, Title
Company
Street
City, State, Zip
Phone:
Fax:
Toll Free:

Date

NOT APPLICABLE

COVAD Communications Company

Exhibit I

Florida Secretary of State Certificate

State of Florida



Department of State

I certify from the records of this office that COVAD COMMUNICATIONS COMPANY is a Fictitious Name registered with the Department of State on April 12, 1999.

The Registration Number of this Fictitious Name is G99102900091.

I further certify that said Fictitious Name Registration is active.

I further certify that this office began filing Fictitious Name Registrations on January 1, 1991, pursuant to Section 865.09, Florida Statutes.

Given under my hand and the
Great Seal of the State of Florida
at Tallahassee, the Capital, this the
Twelfth day of April, 1999



CR2EO22 (1-99)

Katherine Harris

Katherine Harris
Secretary of State

State of Florida



Department of State

I certify the attached is a true and correct copy of the application by DIECA COMMUNICATIONS, INC., a Virginia corporation, authorized to transact business within the State of Florida on May 12, 1998 as shown by the records of this office.

The document number of this corporation is F98000002704.

Given under my hand and the
Great Seal of the State of Florida
at Tallahassee, the Capitol, this the
Twelfth day of May, 1998



CR2EO22 (2-95)

Sandra B. Northam

Sandra B. Northam
Secretary of State

APPLICATION BY FOREIGN CORPORATION FOR AUTHORIZATION TO TRANSACT BUSINESS IN FLORIDA

IN COMPLIANCE WITH SECTION 607.1503, FLORIDA STATUTES, THE FOLLOWING IS SUBMITTED TO REGISTER A FOREIGN CORPORATION TO TRANSACT BUSINESS IN THE STATE OF FLORIDA:

1. DIECA Communications, Inc. (Name of corporation: must include the word "INCORPORATED", "COMPANY", "CORPORATION" or words or abbreviations of like import in language as will clearly indicate that it is a corporation instead of a natural person or partnership if not so contained in the name at present.)

2. Virginia (State or country under the law of which it is incorporated)

3. 77-0470016 (FEI number, if applicable)

4. 9/26/97 (Date of Incorporation)

5. Perpetual (Duration: Year corp. will cease to exist or "perpetual")

6. upon qualification (Date first transacted business in Florida. (SEE SECTIONS 607.1501, 607.1502, AND 817.155, F.S.)

7. c/o Covad Communications, 3560 Bassett St. Santa Clara, CA 95054 (Current mailing address)

8. Telecommunication services and related lawful businesses. (Purpose(s) of corporation authorized in home state or country to be carried out in the state of Florida)

9. Name and street address of Florida registered agent: (P.O. Box or Mail Drop Box NOT acceptable)

Name: NRAI Services, Inc.

Office Address: 526 E. Park Ave.

Tallahassee, Florida, 32301 (Zip Code)

10. Registered agent's acceptance:

Having been named as registered agent and to accept service of process for the above stated corporation at the place designated in this application, I hereby accept the appointment as registered agent and agree to act in this capacity. I further agree to comply with the provisions of all statutes relative to the proper and complete performance of my duties, and I am familiar with and accept the obligations of my position as registered agent.

Andrea Stark for NRAI Services, Inc. (Registered agent's signature)

11. Attached is a certificate of existence duly authenticated, not more than 90 days prior to delivery of this application to the Department of State, by the Secretary of State or other official having custody of corporate records in the jurisdiction under the law of which it is incorporated.

FILED SECRETARY OF STATE DIVISION OF CORPORATIONS MAY 12 PM 2:50

12. Names and addresses of officers and/or directors: (Street address ONLY- P. O. Box NOT acceptable)

A. DIRECTORS (Street address only- P. O. Box NOT acceptable)

Chairman: Charles J. McMinn

Address: 3560 Bassett St., Santa Clara, CA 95054

Vice Chairman: Dhruv Khanna

Address: 3560 Bassett St.

Santa Clara, CA 95054

Director: Timothy P. Laehy

Address: 3560 Bassett St.

Santa Clara, CA 95054

Director: _____

Address: _____

B. OFFICERS (Street address only- P. O. Box NOT acceptable)

President: Charles J. McMinn

Address: 3560 Bassett St.

Santa Clara, CA 95054

Vice President: Dhruv Khanna

Address: 3560 Bassett St.

Santa Clara, CA 95054

Secretary: Dhruv Khanna

Address: 3560 Bassett St.

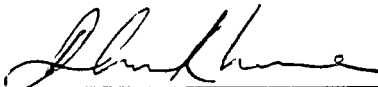
Santa Clara, CA 95054

Treasurer: Timothy P. Laehy

Address: 3560 Bassett St., Santa Clara, CA 95054

FILED
SECRETARY OF STATE
DIVISION OF CORPORATIONS
90 JAN 12 PM 2:50

NOTE: If necessary, you may attach an addendum to the application listing additional officers and/or directors.

13. 
(Signature of Chairman, Vice Chairman, or any officer listed in number 12 of the application)

14. Dhruv Khanna, Vice President
(Typed or printed name and capacity of person signing application)

COVAD Communications Company

Exhibit II

Articles of Incorporation

Commonwealth of Virginia



State Corporation Commission

I Certify the Following from the Records of the Commission:

DIECA Communications, Inc. is a corporation existing under and by virtue of the laws of Virginia, and is in good standing.

The date of incorporation is September 26, 1997.

Nothing more is hereby certified.

FILED
SECRETARY OF STATE
DIVISION OF CORPORATIONS
98 MAY 12 PM 2:50



Signed and Sealed at Richmond
on this Date: May 08, 1998

William J. Bridge

William J. Bridge, Clerk of the Commission

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION

November 7, 1997

The State Corporation Commission has found the accompanying articles submitted on behalf of

DIECA COMMUNICATIONS, INC.

to comply with the requirements of law, and confirms payment of all related fees.

Therefore, it is ORDERED that this

CERTIFICATE OF AMENDMENT

be issued and admitted to record with the articles of amendment in the Office of the Clerk of the Commission, effective November 7, 1997 at 09:22 AM.

The corporation is granted the authority conferred on it by law in accordance with the articles, subject to the conditions and restrictions imposed by law.

STATE CORPORATION COMMISSION

By



Commissioner

AMENACPT
CIS20317
97-10-28-0040

ARTICLES OF AMENDMENT
OF
ARTICLES OF INCORPORATION
OF
DIECA COMMUNICATIONS, INC.

The undersigned, pursuant to Chapter 9 of Title 13.1 of the Code of Virginia, state as follows:

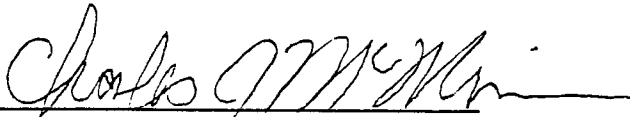
I

The name of this corporation is DIECA Communications, Inc. ("The Corporation").


II

Article V is hereby amended and adopted as follows: The Corporation is organized as a Public Service Company under the laws of the Commonwealth of Virginia. The purpose of the Corporation is to engage in the business of telecommunications services and all activities related thereto.

The above amendment is adopted as of October 24, 1997 and shareholder action is not required.



Charles J. McMinn
Incorporator



Dhruv Khanna
Incorporator

Commonwealth of Virginia



State Corporation Commission

I Certify the Following from the Records of the
Commission:

the foregoing is a true copy of all documents constituting the charter of
DIEGA Communications, Inc..

Nothing more is hereby certified.



Signed and Sealed at Richmond
September 30, 1997
on this Date:

William J. Bridge

William J. Bridge, Clerk of the Commission

COMMONWEALTH OF VIRGINIA
STATE CORPORATION COMMISSION

September 26, 1997

The State Corporation Commission has found the accompanying articles submitted on behalf of

DIECA COMMUNICATIONS, INC.

to comply with the requirements of law, and confirms payment of all related fees.

Therefore, it is ORDERED that this

CERTIFICATE OF INCORPORATION

be issued and admitted to record with the articles of incorporation in the Office of the Clerk of the Commission, effective September 26, 1997.

The corporation is granted the authority conferred on it by law in accordance with the articles, subject to the conditions and restrictions imposed by law.

STATE CORPORATION COMMISSION

By



Commissioner

CORPACPT
CIS20436
97-09-26-0146

**ARTICLES OF INCORPORATION
OF
DIECA COMMUNICATIONS, INC.**

The undersigned, pursuant to Chapter 9 of Title 13.1 of the Code of Virginia, state as follows:

I

The name of this corporation is DIECA Communications, Inc.

II

The number of shares the corporation is authorized to issue is 1,000 shares of Common Stock.

III

The corporation's initial registered office address which is the business address of the initial registered agent is:

5511 Staples Mill Road
Richmond, VA 23228

The initial registered office is physically located in the County of Henrico.

IV

The name of the corporation's initial registered agent is:

Edward R. Parker.

The initial registered agent is an individual who is a resident of Virginia and a member of the Virginia State Bar.



Charles J. McMinn
Incorporator



Dhruv Khanna
Incorporator

Dated: September 23 1997



SECRETARY OF STATE

Handwritten notes: "10/15" and "20 pages"

I, *BILL JONES*, Secretary of State of the State of California, hereby certify:

That the attached transcript has been compared with the record on file in this office, of which it purports to be a copy, and that it is full, true and correct.

IN WITNESS WHEREOF, I execute this certificate and affix the Great Seal of the State of California this

DEC 05 1997



Bill Jones

Secretary of State

ENFORCED
FILED
In the Office of the Secretary of State
of the State of California

**AMENDED AND RESTATED ARTICLES OF INCORPORATION
OF COVAD COMMUNICATIONS COMPANY**

DEC 04 1997

Bill Jones
BILL JONES, Secretary of State

Charles J. McMinn and Dhruv Khanna certify that:

- 1. They are the President and Secretary, respectively, of Covad Communications Company, a California corporation.
- 2. The Articles of Incorporation of this Corporation are hereby amended and restated to read as follows:

ARTICLE I.

The name of this Corporation is Covad Communications Company.

ARTICLE II.

The purpose of this Corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code.

ARTICLE III.

The Corporation is authorized to issue one class of shares to be designated Common Stock. The total number of shares of Common Stock the Corporation shall have authority to issue is 4,000.

Immediately upon the filing of this Amended and Restated Articles of Incorporation, each one thousand (1,000) outstanding shares of the Company's Common Stock will be exchanged and combined, automatically and without further action, into one (1) share of Common Stock. Such combination shall be rounded up to the nearest whole share.

ARTICLE IV.

Section 1. Limitation of Director's Liability. The liability of members of the Board of Directors of the Corporation for monetary damages shall be eliminated to the fullest extent permissible under California law.

Section 2. Indemnification of Corporation Agents. The corporation is authorized to provide indemnification of agents (as defined in Section 317 of the California Corporations Code) to the fullest extent permissible under California law.

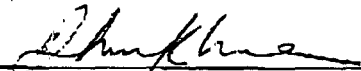
Section 3. Repeal or Modification. Any amendment, repeal or modification of any provision of this Article IV shall not adversely affect any right or protection of an agent of this corporation existing at the time of such amendment, repeal or modification."

3. The foregoing amendment and restatement of Articles of Incorporation has been duly approved by the Board of Directors of the Corporation.

4. The foregoing amendment and restatement of Articles of Incorporation has been duly approved by the required vote of shareholders of the Corporation in accordance with Sections 902 and 903 of the California Corporations Code. The total number of outstanding shares of Common Stock of the Corporation is 3,494,568. The number of shares voting in favor of the amendment equaled or exceeded the vote required. The percentage vote required was 100% of the outstanding shares of Common Stock.



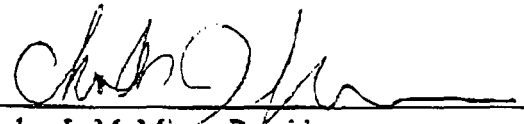
Charles J. McMinn, President



Dhruv Khanna, Secretary

The undersigned declare under penalty of perjury under the laws of the State of California that the matters set forth in the foregoing certificate are true and correct of their own knowledge.

Executed at Santa Clara, California on November 24, 1997.



Charles J. McMinn, President



Dhruv Khanna, Secretary

State of New York }
Department of State } ^{ss:}

I hereby certify that the annexed copy has been compared with the original document in the custody of the Secretary of State and that the same is a true copy of said original.

Witness my hand and seal of the Department of State on

FEB 04 1997



A handwritten signature in cursive script, appearing to read "J. L. ...", followed by a horizontal line.

Special Deputy Secretary of State

E-12

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APPLICATION FOR AUTHORITY

OF

COVAD COMMUNICATIONS COMPANY

(Pursuant to Section 1304 of the Business Corporation Law)

FIRST: The name of the corporation is Covad Communications Company. The corporation shall use the name Covad Communications Company in the State of New York.

SECOND: The jurisdiction of incorporation of the corporation is the State of California. The date of incorporation of the corporation is October 8, 1996.

THIRD: The business which the corporation proposes to do in the State of New York is as follows:

To engage in any act or activity permitted by the laws of California for which corporations may be organized under the Business Corporation Law of the State of New York, provided that the corporation is not to engage in any act or activity requiring the consent or approval of any state official, department, board, agency, or other body without such consent or approval first being obtained.

FOURTH: The office of the corporation in the state of New York is to be located in the County of Westchester.

FIFTH: The Secretary of State of the State of New York is designated as the agent of the corporation upon whom process against the corporation may be served. The post office address without the State of New York to which the Secretary of State of the State of New York shall mail a copy of any process against the corporation served upon said Secretary of State is Dhruv Khanna, Convergence Law Group, 742 Alester Ayenue, Palo Alto, CA 94303.

SIXTH: The corporation has not, since its incorporation, engaged in any activity in the State of New York except as set forth in paragraph (b) of Section 1301 of the Business Corporation Law.

IN WITNESS WHEREOF, I have subscribed this document on the date set forth below and do hereby affirm, under the penalties of perjury, that the statements contained therein have been examined by me and are true and correct.

Executed on this 24th day of January, 1997.



Dhruv Khanna, - Vice President
Covad Communications Company

COVAD Communications Company

Exhibit III

Management Profiles

Management - Covad Executive Staff



Charles E. Hoffman, *President and Chief Executive Officer*

A 25-year telecommunications veteran, Hoffman brings a wealth of telecom and broadband experience to Covad from the wireless, cable, local and long-distance sectors. He joined Covad in June 2001, ushering the company through a pre-negotiated Chapter 11, which effectively eliminated \$1.4 billion in debt. Hoffman also led Covad in securing a \$150 million investment in the company from SBC Communications and dramatically reducing expenses leading to an expectation of cash flow positive operations in the second half of 2003.

Prior to joining Covad, Hoffman was President and Chief Executive Officer of Rogers AT&T, Canada's largest, national wireless service provider, with over three million wireless subscribers. Under his leadership, the company grew from fourth to first place in a market of four national wireless providers. He also successfully negotiated the sale of one-third interest in this publicly traded company (NYSE and TSE) to a partnership of AT&T and British Telecom. While at Rogers, Hoffman also served as a Senior Vice President of Rogers Communications, gaining extensive experience with Rogers Cable, Canada's largest cable company, and the aggressive roll-out of their high speed Internet service.

Prior to his years at Rogers, Hoffman served as President, Northeast region for Sprint PCS, a start-up company owned by Sprint, TCI, Comcast, and Cox Communications. He was responsible for operations in the largest region in the U.S., and, with offices in New York City, Philadelphia, Boston, Pittsburgh, Hartford, Albany, and Washington D.C., he successfully launched PCS wireless service in nine markets.

Before joining Sprint PCS, Hoffman spent 16 years at SBC Communications in various senior management positions, including regional manager, general manager, vice president, and president & general manager. While leading SBC's Cellular One operations, he turned around the second and fourth largest SBC markets, Washington/Baltimore and Boston, from underperformers to market leaders in record time. Hoffman also spent two years leading SBC's wireless operations in the country of Mexico. In addition to running Radiomovil DIPSA, S.A. de C.V. (Telcel), the national wireless carrier, as Director General, he was also Managing Director-Wireless for SBC International. During this period, Hoffman increased market share from 49 percent to 65 percent.

Hoffman began his career at IBM in 1976 in marketing. Prior to beginning his career in wireless, he also spent two years at Southwestern Bell Telephone Co. and two years as a national account manager for AT&T.

Hoffman received a Masters of Business Administration degree from University of Missouri, St. Louis. He and his wife Maureen have four children and one grandson.

Patrick (Pat) Bennett, *Executive Vice President & General Manager, Covad Direct*

Patrick (Pat) Bennett is responsible for driving Covad's direct sales and retail channel development. This position compliments our existing wholesale sales and enables us to further leverage our direct sales efforts and strengthen our existing sales channels. In this role, Mr. Bennett also manages all Covad.net direct channel sales and support, telesales and retail channel sales and development. Mr. Bennett brings to Covad 19 years of successful sales development and management expertise, including the development of effective customer care, sales and marketing organizations, channel development and strategic planning. He most recently joined Covad from TESSCO Technologies, Inc., a leading provider of wireless communication solutions, where he was senior vice president of marketing and product development. Prior to TESSCO, Mr. Bennett was executive vice president and chief operating officer of Rogers Wireless, Inc., Canada's largest wireless communications service provider. As a member of the senior management team, Mr. Bennett was instrumental in driving significant improvements in all operating metrics of the business. Preceding Rogers Wireless, Mr. Bennett joined the start-up organization of Sprint PCS as area vice president. In this role, he was responsible for launching service in Sprint PCS's third largest market, Philadelphia, and later managing the Washington/Baltimore area. He was also vice president of Sales and Marketing for Cellular One in Washington/Baltimore and president and general manager of Communications Electronics, Inc., along with being vice president and general manager for American Beeper Associates in Columbia, Maryland. Mr. Bennett began his career as a regional sales manager for Metromedia, the predecessor to Cellular One.

P. Michael Hanley, Senior Vice President, Organizational Transformation

Mr. Hanley functions as chief of staff to the CEO. He has overall responsibility for the Human Resource and Real Estate/Procurement functions and oversight of strategy and organizational communications. He is responsible for driving organizational change and ensuring the organization is optimized to achieve corporate objectives. A proven and successful leader in high-volume, customer-focused businesses, Mr. Hanley brings 18 years of experience including a strong ability to instill a strategic business focus within the management team and an ability to identify key business issues while driving necessary change. Mr. Hanley most recently joins Covad from Rogers Wireless, Inc. Canada's largest wireless communications service provider. As a member of the senior management team, Mr. Hanley led a cultural shift across the organization that provided a firm foundation of personal accountability and a clear understanding of strategic corporate goals. Prior to Rogers Wireless, Mr. Hanley held increasingly senior roles within the Toronto-Dominion Bank, Bank of Nova Scotia and Canadian Imperial Bank of Commerce.

Anjali Joshi, Executive Vice President Engineering

Anjali Joshi directs all Covad engineering activities including the architecture, implementation and capacity management of Covad's national network. She also leads the development of Covad's network and business operations support systems as well as the corporate information technology infrastructure. Ms. Joshi joined Covad in early 1998 bringing extensive experience in the design of carrier class networking solutions for voice and data. She was instrumental in architecting Covad's network that has proven to be the most cost effective and reliable in the industry. She is recognized as an expert in the area of DSL networks and has influenced FCC and State PUC policies in the areas of DSL deployment, line-sharing and spectrum management. Ms Joshi was invited by the FCC to serve on the Network Reliability and Interoperability Council, which advises the Commission on matters related to the deployment of DSL networks. Prior to joining Covad, she was at AT&T Bell Laboratories, where she managed the planning, design and implementation of several services including AT&T's InterSpan ATM service. Ms. Joshi holds a Bachelors Degree in Electrical Engineering from the Indian Institute of Technology, a Masters Degree in Computer Engineering from SUNY, and a Masters Degree in Engineering Management from Stanford University.



Carol Karney, Senior Vice President, Strategic Partnerships

Mrs. Karney, leads a team that is accountable for driving the top line of the business for Covad. She manages Covad's wholesale sales growth by developing and managing business relationships with Covad's key strategic partners as well as driving high-volume consumer and large business partnerships. Mrs. Karney joined Covad in 1999, as sales vice president to the Midwest. She brings a diverse background in sales, sales management, marketing and finance. Prior to her employment at Covad, she was the global communications manager of the Mobil Oil Corporation, where she lead and developed national and regional promotions through the planning, development and execution of integrated promotion strategies and tactics to drive consumer demand and profitability.

Beth A. Lackey, Senior Vice President, Customer Operations

Ms. Lackey is responsible for managing Service Delivery, Dispatch, Technical Assistance Center (TAC) Repair, and Operations Support. A proven leader in all areas of Covad operations, Ms. Lackey joined Covad in 1999 as Director of Service Delivery where she established the Denver Service Delivery center for provisioning. Shortly thereafter, Ms. Lackey was appointed Vice President of Network Services during which time she was responsible for the TAC and Network Operations Center (NOC) as well as Business Continuity and Disaster Recover. Additionally, Ms. Lackey held positions as Vice President of Western Operations and Vice President, Denver Center of Excellence. With over twenty years of experience in the telecommunications industry, Ms. Lackey initially began her career with U.S. West, where she held increasingly senior positions in sales, customer service, strategic and competitive analysis and network operations. Ms. Lackey holds a Bachelor of Arts degree in business administration with a marketing emphasis from Colorado State University and a Master of Business Administration degree in international business from Regis University.

Andrew S. Lockwood, Senior Vice President of Marketing

Mr. Lockwood is responsible for driving demand for Covad's consumer and business class services. He leads Covad's branding efforts, advertising, and overall marketing direction for the company. Additionally, Mr. Lockwood manages core marketing responsibilities, such as product marketing and development, marketing communications and strategic planning. Mr. Lockwood brings to Covad 21 years of experience in telecommunications, sales and marketing. His last position was senior vice president and general manager of Inktomi's Wireless Division where he was responsible for software engineering, product management, marketing, sales, finance, human resources, and strategy. Prior to his position at Inktomi, Lockwood spent eight years at British Telecommunications (BT) in a variety of senior management positions. Most recently he was vice president of the Advance Alliance where he led the relationship between BT and AT&T Wireless, identifying and implementing joint global product developments and other business initiatives. He was also deputy COO at Telfort Mobil Netherlands, general manager of the Retail and Logistics Sector and held senior positions in Cable Television Services, BT Mobile and BT Cellular. Prior to his time at BT, Lockwood worked for Millicom, Hutchison Telecom, and ICI. Mr. Lockwood was educated at University College of North Wales and Seale-Hayne College in Devon, England.



Morgan McChesney, Senior Vice President, Network Operations

Morgan McChesney is responsible for the management of Covad's network and field operations. Mr. McChesney brings 20 years of telecommunications, broadband operations, and general management experience. Mr. McChesney joined Covad in 1999 and, over the years, has held several different Vice President positions within operations. Prior to joining Covad, Mr. McChesney was a Vice President at AT&T, where he was responsible for building AT&T's local network after their acquisition of Teleport Communications Group (TCG). Mr. McChesney initially joined TCG as the Vice President and General Manager for Atlanta and was with TCG at the time AT&T acquired the company serving as Regional Vice President for the southeast region. He also spent a large portion of his career at Tele-Communications, Inc. (TCI), one of the nation's largest cable television companies. During his time at TCI, Mr. McChesney helped build the company's entry into the local telephone and high speed data business as the Vice President of Operations for the company's newly created telephony business unit. He also served as a Regional Vice President responsible for overall management of one of (TCI)'s largest cable regions and its largest cable market at the time and was directly responsible for turning around the Chicago market and leading the highest revenue producing unit in the company.

David McMorrow, Senior Vice President, Strategic Development

Mr. McMorrow leads a team responsible for strategic business planning and development, focused on Covad's long-term revenue and brand objectives. With over ten years of experience in the telecommunications industry, Mr. McMorrow's experience and knowledge of sales, marketing and industry trends make him well suited to lead Covad's strategic development. Mr. McMorrow joined Covad in 1998 and served as Vice President of Sales for the Eastern Region, managing half of Covad's wholesale revenue. Prior to joining Covad, Mr. McMorrow spent six years at AT&T and WorldCom in various progressively senior managerial positions. Mr. McMorrow holds a Bachelor of Science degree in Marketing from Syracuse University.



Mark Richman, Executive Vice President and Chief Financial Officer

Mr. Richman brings over 18 years of financial management experience to Covad. He joins the company from MainStreet Networks where he was vice president and CFO, and built the finance, accounting and IT functions into departments. Prior to MainStreet, Richman held senior management positions at Adecco S.A. where he was vice president of finance and administration for Adecco U.S., a \$3 billion operating division. He was also vice president and corporate treasurer at the parent company where he raised over \$3 billion in funding through various debt and equity transactions. He also worked for Merisel, Inc., a global computer hardware and software distributor, and was primarily based in London as European finance director. Prior to Merisel, Richman had held various banking positions with ING Capital, Manufacturers Hanover Trust Company and Wells Fargo Bank. Richman holds a Bachelor of Science degree in managerial economics from the University of California at Davis and a Master of Business Administration degree from the Anderson School at UCLA.

Martha Sessums, *Vice President, Corporate Communications*

With over 20 years of experience in managing technology public relations and corporate communications, Ms. Sessums is responsible for overseeing all external and internal communications at Covad. Ms. Sessums joined Covad in 1999 and during that time has developed a strong public relations and communications program that has moved the company from a small start-up to an industry leader. Prior to Covad, Ms. Sessums was the Senior Managing Director at Hill and Knowlton, Inc., where she managed the high technology practice of their San Francisco office. She was also with Avalanche PR for Hill and Knowlton and managed the corporate and alliance public relations activities for Oracle Corporation. In addition, she has held extensive senior corporate communications, public relations, and consulting roles for companies like Brodeur & Partners Public Relations, Network Equipment Technologies, Western Digital Corporation, Apple Computer, and Regis McKenna Public Relations. Ms. Sessums holds a Bachelor of Arts in Communications from California State University, Fullerton. She has a Masters of Business Administration from Santa Clara University. Ms. Sessums also serves as the president and secretary of the Association for Continuing Education, a distance education network provider.

Brad Sonnenberg, *Senior Vice President and General Counsel*

Mr. Sonnenberg manages the legal affairs for Covad, including corporate transactional, litigation and government external affairs, which is responsible for regulatory, legislative and other governmental advocacy and manages Covad's relationship with the Incumbent Local Exchange Carriers (ILECs). Mr. Sonnenberg joined Covad in 1999 and became deputy general counsel in 2000. During his time with Covad, he has set a very high standard of excellence in the legal department and played an integral part in negotiating Covad's pre-negotiated bankruptcy and the subsequent elimination of the company's bondholder debt. Prior to joining Covad, Sonnenberg was an assistant U.S. attorney in the Major Frauds section at the U.S. Attorney's Office in Los Angeles where he focused on prosecuting white-collar crimes. He received his law degree from the University of Chicago School of Law in 1982 and started his legal career as an associate at Debevoise & Plimpton in New York. He also served as an assistant state attorney in Miami, Florida.

COVAD Communications Company

Exhibit IV

Financial Statements

The attached Exhibit will demonstrate that the applicant has:

1. Sufficient financial capability to provide the requested service within the State of Florida;
2. Sufficient financial capability to maintain the requested service;
3. Sufficient financial capability to meet its lease or ownership obligations.

COVAD Communications Company

Exhibit IV

Applicant is a wholly-owned subsidiary of Covad Communications Group, Inc. ("Covad") a publicly traded corporation. Attached is the following information: (i) Covad's latest Annual Report and Form 10Q, (ii) Names and biographies of its Board of Directors (see Exhibit III), and (iii) Names and biographies of its key management (See Exhibit III). As demonstrated by this information, Applicant has sufficient managerial and financial capability to provide and maintain the requested service in the geographic area proposed to be served. In fact, over the last three years, Applicant has provided, and continues to provide, DSL-based services to thousands of Florida customers using a combination of facilities leased from the incumbent local exchange carrier and its own collocated facilities. Applicant, therefore, has demonstrated by both its past operations and the information attached to this application that it has sufficient managerial and financial capability to meet its lease or ownership obligations.

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-Q

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

For the quarterly period ended September 30, 2002

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

For the transition period from _____ to _____ .

Commission file number: 000-25271

Covad Communications Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware
*(State or other jurisdiction
of incorporation or organization)*

77-0461529
*(I.R.S. Employer
Identification Number)*

**3420 Central Expressway
Santa Clara, California**
(Address of principal executive offices)

95051
(Zip Code)

(408) 616-6500

(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 No

APPLICABLE ONLY TO REGISTRANTS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PRECEDING 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 No

As of November 4, 2002 there were 222,999,936 shares outstanding of the Registrant's Common Stock, including Class B Common Stock.

COVAD COMMUNICATIONS GROUP, INC.

FORM 10-Q

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements (Unaudited)

COVAD COMMUNICATIONS GROUP, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2002	December 31, 2001
	(Unaudited)	(Note 1)
	(Amounts in thousands, except share and per share amounts)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 49,120	\$ 207,810
Short-term investments	179,087	76,053
Restricted cash and investments	500	9,203
Accounts receivable, net of allowances of \$6,093 at September 30, 2002 (\$8,483 at December 31, 2001)	32,392	23,245
Unbilled revenue	3,934	4,964
Other receivables	1,560	3,885
Inventories	5,068	7,249
Prepaid expenses and other current assets	12,367	6,689
Total current assets	284,028	339,098
Property and equipment, net	119,654	215,804
Collocation fees, net	45,787	53,464
Investments in unconsolidated affiliates	1,516	4,874
Deferred costs of service activation	44,635	57,962
Deferred customer incentive	3,730	—
Other long-term assets	3,461	3,966
Total assets	<u>\$ 502,811</u>	<u>\$ 675,168</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 13,302	\$ 15,842
Accrued compensation	14,910	16,268
Current portion of capital lease obligations	—	11
Accrued collocation and network service fees	32,603	40,839
Accrued transaction-based taxes	37,384	31,263
Accrued interest	4,308	183
Accrued market development funds and customer incentives	5,550	1,733
Unresolved claims related to bankruptcy proceedings	9,997	22,200
Other accrued liabilities	10,452	8,103
Total current liabilities	128,506	136,442
Long-term debt	50,000	50,000
Collateralized customer deposit	70,080	75,000
Deferred gain resulting from deconsolidation of subsidiary	55,200	55,200
Unearned revenues	79,185	98,697
Total liabilities	382,971	415,339
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding at September 30, 2002 and December 31, 2001	—	—
Common Stock, \$0.001 par value; 590,000,000 shares authorized; 220,499,687 shares issued and outstanding at September 30, 2002 (216,542,210 shares issued and outstanding at December 31, 2001)	220	216
Additional paid-in capital	1,614,422	1,606,737
Deferred stock-based compensation	(203)	(257)
Accumulated other comprehensive loss	(752)	(2,359)
Accumulated deficit	(1,493,847)	(1,344,508)
Total stockholders' equity	119,840	259,829
Total liabilities and stockholders' equity	<u>\$ 502,811</u>	<u>\$ 675,168</u>

See accompanying notes.

COVAD COMMUNICATIONS GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
	(Amounts in thousands, except share and per share amounts) (Unaudited)			
Revenues, net	\$ 96,206	\$ 84,784	\$ 295,605	\$ 243,128
Operating expenses:				
Network and product costs	68,112	103,290	231,576	359,896
Sales, marketing, general and administrative	42,607	46,601	116,636	168,696
Provision for bad debts (bad debt recoveries), net	(1,731)	3,572	312	523
Depreciation and amortization of property and equipment	33,498	36,092	92,882	103,796
Amortization of collocation fees	3,700	1,763	10,990	9,333
Provision for restructuring expenses	-	(130)	-	17,617
Provision for long-lived asset impairment	-	(241)	-	1,989
Litigation-related expenses	1,884	1,907	(9,029)	5,907
Total operating expenses	148,070	192,854	443,367	667,757
Loss from operations	(51,864)	(108,070)	(147,762)	(424,629)
Other income (expense):				
Interest income	1,559	5,063	4,072	23,290
Realized gain (loss) on short-term investments	-	75	(17)	5,912
Other than temporary losses on short- term investments	-	-	-	(1,311)
Provision for impairment of investments in unconsolidated affiliates	-	(9,467)	-	(9,467)
Equity in losses of unconsolidated affiliates	(101)	(5,011)	(704)	(11,626)
Gain (loss) on disposal of investments in unconsolidated affiliates	-	-	(636)	178
Interest expense (contractual interest expense was \$36,169 and \$110,415 for the three and nine months ended September 30, 2001, respectively)	(1,375)	(18,345)	(4,125)	(92,591)
Miscellaneous income (expense), net ..	74	(98)	(167)	394
Reorganization expenses, net	-	(3,896)	-	(3,896)
Other income (expense), net	157	(31,679)	(1,577)	(89,117)
Net loss	\$ (51,707)	\$ (139,749)	\$ (149,339)	\$ (513,746)
Basic and diluted net loss per share	\$ (0.23)	\$ (0.79)	\$ (0.68)	\$ (2.94)
Weighted average number of common shares used in computing basic and diluted net loss per share	220,432,609	176,829,127	218,901,267	174,507,085

See accompanying notes.

COVAD COMMUNICATIONS GROUP, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2002	2001
	(Amounts in thousands)	
	(Unaudited)	
Operating Activities:		
Net loss	\$(149,339)	\$(513,746)
Adjustments to reconcile net loss to net cash used in operating activities:		
Provision for bad debts, net	312	523
Depreciation and amortization	103,872	113,129
Loss on disposition of property and equipment	332	382
Provision for restructuring expenses	—	17,617
Provision for long-lived asset impairment	—	1,989
Non-cash litigation-related expenses	(9,029)	3,140
Amortization of deferred stock-based compensation	227	1,431
Other stock-based compensation	282	4
Amortization (accretion) of interest on investments, net	(92)	(6,837)
Realized loss (gain) on short-term investments	17	(5,912)
Other than temporary losses on short-term investments	—	1,311
Equity in losses of unconsolidated affiliates	704	11,626
Provision for impairment of investment in unconsolidated affiliates	—	9,467
(Gain) loss on disposal of investments in unconsolidated affiliates	636	(178)
Accretion of debt discount and amortization of deferred debt issuance costs	—	20,845
Net changes in operating assets and liabilities:		
Restricted cash	8,703	13,206
Accounts receivable	(9,459)	(6,968)
Unbilled revenue	1,030	756
Inventories	2,181	5,488
Prepaid expenses and other current assets	(3,191)	1,473
Deferred costs of service activation	13,327	(9,038)
Accounts payable	(2,540)	(45,024)
Unresolved claims related to bankruptcy proceedings	(2,913)	—
Prepetition accounts payable and accrued liabilities subject to compromise	—	(7,621)
Postpetition accounts payable and accrued liabilities	—	14,670
Collateralized customer deposit	(4,920)	—
Other current liabilities	8,417	(14,611)
Unearned revenues	(19,109)	(13,845)
Net cash used in operating activities	(60,552)	(406,723)
Investing Activities:		
Cash relinquished as a result of deconsolidating a subsidiary	—	(1,599)
Purchases of short-term investments	(213,681)	(561,986)
Maturities of short-term investments	70,988	487,508
Sales of short-term investments	40,000	335,376
Purchase of restricted investments in connection with bankruptcy proceedings	—	(257,202)
Redemption of restricted investments in connection with bankruptcy proceedings	—	—
Redemption of other restricted investments	—	13,437
Purchases of property and equipment	(12,323)	(16,685)
Proceeds from sales of property and equipment	13,451	1,483
Recovery of internal use software costs	458	2,000
Payment of collocation fees	(1,963)	(4,233)
Proceeds from sales of investments in unconsolidated affiliates	3,360	1,223
Net cash used in investing activities	(99,710)	(678)
Financing Activities:		
Principal payments on long-term debt	—	(8,394)
Principal payments under capital lease obligations	(11)	(1,086)
Proceeds from common stock issuance	1,583	3,924
Repurchase of restricted stock	—	(172)
Net cash provided by (used in) financing activities	1,572	(5,728)
Net decrease in cash and cash equivalents	(158,690)	(413,129)
Cash and cash equivalents at beginning of period	207,810	558,440
Cash and cash equivalents at end of period	<u>\$ 49,120</u>	<u>\$ 145,311</u>
Supplemental Disclosures of Cash Flow Information:		
Cash paid during the period for interest	<u>\$ —</u>	<u>\$ 66,542</u>

See accompanying notes.

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2002 and 2001

(All dollar amounts are presented in thousands, except share and per share amounts)

(Unaudited)

1. Basis of Presentation and Summary of Significant Accounting Policies

The condensed consolidated financial statements include the accounts of Covad Communications Group, Inc. ("Covad") and its wholly-owned subsidiaries (collectively, the "Company"). All significant intercompany accounts and transactions have been eliminated in consolidation.

The condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the condensed consolidated financial statements have been included. Operating results for the three and nine months ended September 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002.

The Company's business plan includes certain discretionary spending in 2002 that is predicated on certain revenue growth assumptions. If necessary, the Company will curtail this discretionary spending so that it can continue as a going concern at least through January 1, 2003 using only its unrestricted cash, cash equivalents and short-term investment balances in existence as of December 31, 2001. Additionally, based on the advice of legal counsel, the Company believes it is more likely than not that certain securities litigation described in Note 8 will ultimately be settled in accordance with the terms of the memorandum of understanding ("MOU") dated August 10, 2001 executed by the Company and the plaintiffs in such securities litigation. Therefore, the Company does not believe that the ultimate settlement of this securities litigation will have a material adverse effect on its ability to continue as a going concern at least through January 1, 2003. However, in the event (i) the MOU is not ultimately approved by the United States District Court and/or (ii) the settlement of the aforementioned securities litigation ultimately requires the Company to disburse additional cash, the Company will reduce other discretionary spending so that it can continue as a going concern at least through January 1, 2003 using only its unrestricted cash, cash equivalents and short-term investment balances in existence as of December 31, 2001. The Company does not believe any such curtailment of its discretionary spending, if necessary, will have a material adverse effect on the overall execution of its business plan.

The condensed consolidated balance sheet as of December 31, 2001 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements.

All information included in this report should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2001.

Use of Estimates

The preparation of 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 at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ materially from these estimates. The Company's critical accounting estimates include (i) revenue recognition and the establishment of accounts receivable allowances, (ii) inventory valuation, (iii) reorganization and restructuring liabilities, (iv) useful life assignments and impairment evaluations associated with property and equipment and collocation fees, (v) anticipated

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

outcomes of legal proceedings and other disputes, (vi) transaction-based tax liabilities and (vii) valuation allowances associated with deferred tax assets.

Long-Lived Assets

As of December 31, 2001, the Company's estimated annual amortization expenses associated with collocation fees for the next five years were as follows:

2002	\$13,177
2003	\$13,177
2004	\$13,177
2005	\$13,177
2006	\$ 756

Effective January 1, 2001, the Company reduced the remaining estimated useful lives of all long-lived assets, excluding building and leasehold improvements, that previously had estimated useful lives in excess of five years such that the residual balances and any subsequent additions are now depreciated or amortized over five years using the straight-line method. This change in accounting estimate increased the Company's net loss by \$2,900 (\$0.02 per share) and \$9,200 (\$0.05 per share) for the three and nine months ended September 30, 2001, respectively.

As part of the continuing evaluation of the Company's network assets during the three months ended September 30, 2002, certain matters were identified related to prior financial reporting periods that necessitated the recording of additional expenses. Such matters were related to (i) changes in the Company's network configuration, which necessitated reductions of the remaining estimated useful lives of certain network equipment and (ii) the capitalization of certain network and product costs that should have been charged to operating expenses. Accordingly, for the three months ended September 30, 2002, the Company has recorded (i) additional depreciation expense of \$9,584 and (ii) additional network and product costs of \$1,215. The Company does not believe these amounts are material to the periods in which they should have been recorded, nor does it expect that the expenses will be material to its consolidated operating results for the year ending December 31, 2002. However, if these adjustments are ultimately deemed to be material to the Company's consolidated operating results for the year ending December 31, 2002, the Company will need to restate prior financial reporting periods, including the current period. The impact on prior financial reporting periods would be as follows: net loss for the three months ended June 30, 2002 would be increased by \$1,292 (\$0.01 per share), net loss for the three months ended March 31, 2002 would be increased by \$1,099 (\$0.01 per share), net income for the year ended December 31, 2001 would be decreased by \$8,057 (\$0.04 per share) and net loss for the year ended December 31, 2000 would be increased by \$351 (\$0.00 per share).

Basic and Diluted Net Loss Per Share

Basic net loss per share is computed using the weighted average number of shares of the Company's common stock outstanding during the period, less the weighted average number of outstanding common shares subject to repurchase.

Diluted per share amounts are determined in the same manner as basic per share amounts, except that the number of weighted average common shares used in the computations includes dilutive common shares subject to repurchase and is increased assuming the (i) exercise of dilutive stock options and warrants using the treasury stock method and (ii) conversion of dilutive convertible debt instruments. However, diluted net loss per share is the same as basic net loss per share in the periods presented in the accompanying condensed consolidated statements of operations because the impact of (i) common shares subject to repurchase, (ii) the

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

assumed exercise of outstanding stock options and warrants and (iii) the assumed conversion of convertible debt instruments is not dilutive.

The following table presents the calculation of weighted average common shares used in the computations of basic and diluted net loss per share presented in the accompanying condensed consolidated statements of operations:

	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
	<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Weighted-average number of shares of common stock outstanding	220,433,234	177,653,940	218,910,100	175,585,866
Less weighted average number of shares of common stock subject to repurchase	<u>625</u>	<u>824,813</u>	<u>8,833</u>	<u>1,078,781</u>
Weighted average number of common shares used in computing basic and diluted net loss per share	<u>220,432,609</u>	<u>176,829,127</u>	<u>218,901,267</u>	<u>174,507,085</u>

Comprehensive Loss

Significant components of the Company's comprehensive loss are as follows:

	<u>Cumulative Amounts</u>	<u>Three Months Ended</u> <u>September 30,</u>		<u>Nine Months Ended</u> <u>September 30,</u>	
		<u>2002</u>	<u>2001</u>	<u>2002</u>	<u>2001</u>
Net loss	\$(1,493,847)	\$(51,707)	\$(139,749)	\$(149,339)	\$(513,746)
Unrealized gains (losses) on available-for-sale securities	210	78	(675)	265	(2,132)
Foreign currency translation adjustment	<u>(962)</u>	<u>—</u>	<u>(32)</u>	<u>1,342</u>	<u>(706)</u>
Comprehensive loss	<u>\$(1,494,599)</u>	<u>\$(51,629)</u>	<u>\$(140,456)</u>	<u>\$(147,732)</u>	<u>\$(516,584)</u>

Recent Accounting Pronouncements

In July 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 146, "Accounting for Costs Associated with an Exit or Disposal Activity." SFAS No. 146 revises the accounting for exit and disposal activities under Emerging Issues Task Force ("EITF") Issue 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)" by extending the period in which expenses related to restructuring activities are reported. A commitment to a plan to exit an activity or dispose of long-lived assets will no longer be sufficient to record a one-time charge for most restructuring activities. Instead, companies will record exit or disposal costs when they are incurred and can be measured at fair value. In addition, the resultant liabilities will be subsequently adjusted for changes in estimated cash flows. SFAS No. 146 is effective prospectively for exit or disposal activities initiated after December 31, 2002. Companies may not restate previously issued financial statements for the effect of the provisions of SFAS No. 146, and liabilities that a company previously recorded under EITF Issue 94-3 are grandfathered. The Company will adopt SFAS No. 146 on January 1, 2003 and does not believe that the adoption of SFAS No. 146 will have a material effect on its consolidated financial statements.

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." SFAS No. 145 rescinds SFAS No. 4, "Reporting Gains and Losses from Extinguishment of Debt," which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS No. 145, which is effective in periods beginning after May 15, 2002, requires that gains or losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria of APB Opinion No. 30. The Company is required to adopt the provisions of SFAS No. 145 on January 1, 2003 and does not believe that the adoption of SFAS No. 145 will have a material effect on its consolidated financial statements.

On January 1, 2002, the Company adopted SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," and provides a single accounting model for long-lived assets to be disposed of. The adoption of SFAS No. 144 had no effect on the Company's condensed consolidated financial statements.

On January 1, 2002, the Company adopted SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangibles Assets." SFAS No. 141 eliminates the pooling-of-interests method of accounting for business combinations, except for qualifying business combinations that were initiated prior to July 1, 2001. Under SFAS No. 142, goodwill and indefinite-lived intangible assets are no longer amortized, but are reviewed annually for impairment or more frequently if impairment indicators arise. The adoption of SFAS Nos. 141 and 142 had no effect on the Company's condensed consolidated financial statements.

On January 1, 2002, the Company adopted EITF guidance regarding the provision in EITF Issue 00-25, "Vendor Income Statement Characterization of Consideration from a Vendor to a Retailer," dealing with consideration from a vendor to a reseller under cooperative advertising and other arrangements. This provision of EITF Issue 00-25 states that consideration from a vendor to a reseller of the vendor's products or services is presumed to be a reduction of the selling price of the vendor's products or services, unless the vendor (i) receives an identifiable benefit in return for the consideration and (ii) can reasonably estimate the fair value of the benefit received. If the amount of consideration paid by the vendor exceeds the estimated fair value of the benefit received, the excess amount is to be recorded by the vendor as a reduction of revenues. The adoption of this new guidance did not have a material effect on the Company's condensed consolidated financial statements.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived assets. The Company is required to adopt SFAS No. 143 on January 1, 2003, and it does not believe the adoption of SFAS No. 143 will have a material effect on its consolidated financial statements.

On January 1, 2001, the Company adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. SFAS No. 133 standardizes the accounting for derivatives and hedging activities and requires that all derivatives be recognized in the statement of financial position as either assets or liabilities at fair value. Changes in the fair value of derivatives that do not meet the hedge accounting criteria are required to be reported in operations. The adoption of SFAS No. 133 had no effect on the Company's condensed consolidated financial statements.

Reclassifications

Certain balances in the Company's 2001 condensed consolidated financial statements have been reclassified to conform to the presentation in 2002.

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

2. Revenue Recognition and Change in Accounting Principle

Revenues from recurring service are recognized when (i) persuasive evidence of an arrangement between the Company and the customer exists, (ii) service has been provided to the customer, (iii) the price to the customer is fixed and determinable and (iv) collectibility of the sales price is reasonably assured. Revenues earned for which the customer has not been billed are recorded as "Unbilled revenues" in the condensed consolidated balance sheets. Amounts billed in advance of providing service are deferred and recorded as an element of the condensed consolidated balance sheet caption "Unearned revenues." Included in revenues are Federal Universal Service Fund charges billed to customers aggregating \$1,861 and \$7,757 for the three and nine months ended September 30, 2002, respectively, and \$2,967 and \$10,094 for the three and nine months ended September 30, 2001, respectively.

The Company has over 140 wholesale customers. However, for the three and nine months ended September 30, 2002, the Company's 30 largest wholesale customers collectively comprised 93.6% and 93.4%, respectively, of its total wholesale revenues and 80.1% and 80.3%, respectively, of its total revenues. As of September 30, 2002, receivables from these customers collectively comprised 81.9% of the Company's gross accounts receivable balance. For the three and nine months ended September 30, 2001, the Company's 30 largest wholesale customers collectively comprised 90.6% and 82.6%, respectively, of its total wholesale revenues and 81.0% and 74.1%, respectively, of its total revenues. As of September 30, 2001, receivables from these customers collectively comprised 86.2% of the Company's gross accounts receivable balance.

For the three months ended September 30, 2002, two wholesale customers (Earthlink, Inc. and AT&T Internet Services) individually accounted for 20.7% and 10.0%, respectively, of the Company's total revenues. For the nine months ended September 30, 2002, these wholesale customers individually accounted for 20.5% and 9.2%, respectively, of the Company's total revenues. As of September 30, 2002, receivables from these wholesale customers individually accounted for 39.3% and 8.2%, respectively, of the Company's gross accounts receivable balance.

For the three months ended September 30, 2001, two wholesale customers (Earthlink, Inc. and XO Communications) individually accounted for 17.8% and 10.9%, respectively, of the Company's total revenues. For the nine months ended September 30, 2001, these wholesale customers individually accounted for 16.8% and 10.8%, respectively, of the Company's total revenues. As of September 30, 2001, receivables from these wholesale customers comprised 16.9% and 16.5%, respectively, of the Company's gross accounts receivable balance.

Some of the Company's Internet service provider ("ISP") and telecommunications carrier customers are experiencing financial difficulties. During the three and nine months ended September 30, 2002 and 2001, certain of these financially distressed customers either (i) were not current in their payments for the Company's services or (ii) were essentially current in their payments but, subsequent to the end of the reporting period, the financial condition of such customers deteriorated significantly and certain of them have filed for bankruptcy protection. Based on this information, the Company determined that (i) the collectibility of revenues from these customers was not reasonably assured or (ii) its ability to retain some or all of the payments received from the customers who have filed for bankruptcy protection was not reasonably assured. Revenue related to customers that do not demonstrate the ability to pay for services in a timely manner, but who have not filed for bankruptcy protection, is recognized when cash for those services is received, after the collection of all previous outstanding accounts receivable balances. Payments received from financially distressed customers during a defined period prior to their filing of petitions for bankruptcy protection are recorded in the consolidated balance sheet caption "Unearned revenues" if the Company's ability to retain these payments is not reasonably assured. During the three months ended March 31, 2002, as a result of developments in the bankruptcy proceedings of certain of the Company's customers, the Company determined that its ability to retain certain payments received from these bankrupt customers prior to January 1, 2002 was now reasonably assured. Accordingly, during the three months ended March 31, 2002, the Company

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

recognized revenues that were deferred as of December 31, 2001 aggregating \$3,307 (none during the three months ended June 30, 2002). During the three months ended September 30, 2002, due to developments in the bankruptcy proceeding of another customer, the Company determined that its ability to retain certain payments received from this bankrupt customer prior to January 1, 2002 was now reasonably assured. Accordingly, the Company recognized revenues of \$1,120 that were deferred as of December 31, 2001.

A number of the Company's customers are currently in bankruptcy proceedings. Revenues from these customers accounted for approximately 18.9% and 19.6% of the Company's total revenues for the three and nine months ended September 30, 2002, respectively, and 17.7% and 20.4% of its total revenues for the three and nine months ended September 30, 2001, respectively. Although WorldCom, a wholesale customer of the Company, filed for bankruptcy protection in July 2002, the Company continued to recognize revenues from WorldCom on an accrual basis based on the revenue recognition criteria described above. Consequently, the disclosures in the following paragraph exclude amounts pertaining to WorldCom because this customer is not presently classified as financially distressed by the Company. The Company continues to attempt to migrate end users from certain of these financially distressed customers to the extent it is legally and operationally feasible.

The Company issued billings to its financially distressed customers, including those that have filed for bankruptcy protection (excluding WorldCom, as noted above), aggregating \$7,447 and \$39,779 during the three and nine months ended September 30, 2002, respectively, that were not recognized as revenues or accounts receivable in the condensed consolidated financial statements, as compared to the corresponding amounts of \$15,317 and \$52,636 for the three and nine months ended September 30, 2001, respectively. However, the Company ultimately recognized revenues from certain of these financially distressed customers on a cash basis (as described above) aggregating \$12,077 and \$43,446 during the three and nine months ended September 30, 2002, respectively, and \$5,839 and \$15,715 during the three and nine months ended September 30, 2001, respectively, some of which related to services provided in prior periods. The Company had contractual receivables from its financially distressed customers, including receivables of \$6,026 from customers that have filed for bankruptcy protection (excluding WorldCom, as noted above), totaling \$6,250 as of September 30, 2002 that are not reflected in the accompanying condensed consolidated balance sheet as of such date.

The Company has obtained information indicating that some of its customers, including WorldCom, who (i) were essentially current in their payments for the Company's services prior to September 30, 2002, and (ii) have subsequently paid all or significant portions of the respective amounts recorded as accounts receivable by the Company as of September 30, 2002, may become financially distressed. Revenues from these customers accounted for approximately 25.6% and 25.1% of the Company's total revenues for the three and nine months ended September 30, 2002, respectively. As of September 30, 2002, receivables from these customers comprised 28.6% of the Company's gross accounts receivable balance. If these customers are unable to demonstrate their ability to pay for the Company's services in a timely manner in periods ending subsequent to September 30, 2002, revenue from these customers will be recognized on a cash basis as described above.

The Company has obtained persuasive evidence indicating that the financial condition of one of its customers, which was designated as financially distressed in 2000, improved significantly during the three months ended June 30, 2002, principally as a result of a capital infusion during this period. Consequently, management concluded that collection of the Company's billings to this customer was now reasonably assured. Therefore, the Company resumed recognition of revenues from this customer on an accrual basis during the second quarter of 2002, which resulted in the recognition of a receivable balance and revenues in the amount of approximately \$1,542 as of and for the three months ended June 30, 2002 that relate to services rendered in periods ended prior to April 1, 2002. The Company collected such receivable balance in full during

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

July 2002. No similar amounts were recognized during the other periods reported in the accompanying condensed consolidated financial statements.

The Company has billing disputes with certain of its customers. These disputes arise in the ordinary course of business in the telecommunications industry and their impact on the Company's accounts receivable and revenues can be reasonably estimated based on historical experience. Accordingly, the Company maintains an allowance, through charges to revenues (which amounted to \$540 and \$2,130 during the three and nine months ended September 30, 2002, respectively, and \$1,293 and \$9,253 during the three and nine months ended September 30, 2001, respectively), based on its estimate of the ultimate resolution of these disputes.

During the fourth quarter of 2000, retroactive to January 1, 2000, the Company changed its method of accounting for up-front fees associated with service activation and the related incremental direct costs in accordance with SEC Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements." Previously, the Company had recognized up-front fees as revenues upon activation of service. Under the new accounting method, which was adopted retroactive to January 1, 2000, the Company now recognizes up-front fees associated with service activation over the expected term of the customer relationship, which is presently estimated to be 24 months, using the straight-line method. Also as a result of the adoption of SAB No. 101, retroactive to January 1, 2000, the Company now treats the incremental direct costs of service activation (which consist principally of customer premise equipment, service activation fees paid to other telecommunications companies and sales commissions) as deferred charges in amounts that are no greater than the up-front fees that are deferred, and such deferred incremental direct costs are amortized to network and product costs using the straight-line method over 24 months. The cumulative effect of the change in accounting principle resulted in a charge to operations of \$9,249, which was included in net loss for the year ended December 31, 2000. For the three and nine months ended September 30, 2001, the Company recognized \$2,697 and \$10,640, respectively, in revenue that was included in the cumulative effect adjustment as of January 1, 2000 (none during the three or nine months ended September 30, 2002). The effect of that revenue during the three and nine months ended September 30, 2001 was to reduce net loss by \$688 and \$2,777, respectively.

3. Customer Warrants

On September 4, 2002, in conjunction with the execution of a five-year Broadband Internet Access Service Agreement (the "Broadband Agreement") with America Online, Inc. ("AOL"), a wholesale customer, the Company granted AOL three warrants to purchase an aggregate of 3,500,000 shares of its common stock at prices of \$1.06, \$3.00 and \$5.00 per share. Such warrants were immediately exercisable, fully vested and non-forfeitable at the date of grant. Accordingly, the measurement date for these warrants was the date of grant. The aggregate fair value of such warrants of approximately \$3,800, which was determined using a Black-Scholes valuation model and the following assumptions: closing price of the Company's common stock on September 4, 2002 of \$1.14 per share; expected life of seven years (which is also the contractual life of the warrants); dividend yield of zero; volatility of 1.56; and a risk-free interest rate of 3.63%, was recorded as a deferred customer incentive and will be recognized as a reduction of revenues on a straight-line basis over the five-year term of the Broadband Agreement because management believes that future revenues from AOL will exceed the fair value of the warrants described above. However, because the Broadband Agreement contains no minimum purchase commitment and is cancelable under certain circumstances by AOL, the Company will continue to monitor the recoverability of the deferred customer incentive balance described above in periods ending subsequent to September 30, 2002.

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

4. Asset Purchase

On January 3, 2002, the Company purchased substantially all of the assets of InternetConnect, a related party, in an auction supervised by the United States Bankruptcy Court for the Central District of California. The purchase price for these assets was \$5,470 in cash, \$235 of which had been deposited with InternetConnect's agent prior to December 31, 2001. (Under the terms of the asset purchase agreement, the Company may be required to pay additional cash of up to \$1,880, depending upon the outcome of a previous post-petition bankruptcy claim filed against InternetConnect by the Company, which is still pending before the court.) The Company did not assume any liabilities or obligations of InternetConnect or hire any of InternetConnect's employees. In addition, the Company does not believe the assets acquired from InternetConnect constitute a self-sustaining business.

The tangible assets of InternetConnect purchased by the Company consisted of accounts receivable, refundable deposits and property and equipment. The Company also purchased the right, but not the obligation, to assume InternetConnect's customer contracts. However, the Company did not exercise this right. Instead, the Company solicited the approximate 9,250 digital subscriber line ("DSL"), T-1, virtual private network ("VPN") and dial-up customers of InternetConnect, and approximately 6,200 of such customers executed new contracts with the Company and its resellers subsequent to January 3, 2002.

The Company has allocated the aforementioned purchase price based on the estimated fair values of the elements of this transaction as of January 3, 2002, as follows:

Accounts receivable	\$1,386
Refundable deposits	349
Property and equipment	61
Customer acquisition costs	<u>3,674</u>
	<u>\$5,470</u>

The customer acquisition costs of \$3,674 described above were charged to network and product costs for the three months ended March 31, 2002 (i) because the Company's relationship with InternetConnect's former customers did not exist as of January 3, 2002 and (ii) based on the Company's accounting policy for costs of this nature that are not accompanied by up-front fees (Note 2).

5. Property Sale

During the fourth quarter of 2001, the Company tentatively decided to sell land, a building and certain improvements located in Manassas, Virginia. This property was part of the Company's wholesale segment. In March 2002, the Company entered into a non-binding letter of intent with a third party to sell such property for \$14,000, which was subject to approval by the Company's board of directors. In April 2002, the Company received the necessary approval from its board of directors to proceed with the sale of this property (at which time the Company suspended depreciation of the building and related improvements when such assets had an aggregate carrying value of \$13,201). In June 2002, the Company completed the sale of this property and recognized a gain of \$133 in the accompanying condensed consolidated statements of operations, which represents the net proceeds of \$13,334 less the aggregate carrying value of the property as described above.

6. Reorganization Under Bankruptcy Proceedings

On August 15, 2001 (the "Petition Date"), Covad, excluding its operating subsidiaries, filed a voluntary petition (the "Petition") under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code") for the purpose of confirming its pre-negotiated First Amended Plan of Reorganization, as modified on November 26, 2001 (the "Plan"), with the majority holders of its senior notes. The Petition was filed with the

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

United States Bankruptcy Court for the District of Delaware (the “Bankruptcy Court”) and was assigned Case No.01-10167 (JJF). As of the Petition Date, Covad commenced operating its business and managing its properties as a debtor-in-possession. On December 13, 2001, the Bankruptcy Court entered an order confirming the Plan and, on December 20, 2001, the Plan was consummated and Covad emerged from bankruptcy. However, the Bankruptcy Court still maintains jurisdiction over certain administrative matters related to the implementation of the Plan, including the unresolved claims described below.

Condensed financial information of Covad as of and for the three and nine months ended September 30, 2001 is as follows:

CONDENSED BALANCE SHEET

As of September 30, 2001

(Unaudited)

ASSETS

Current assets:	
Cash and cash equivalents	\$ 28,000
Restricted cash and investments	270,600
Other receivables	<u>700</u>
Total current assets	299,300
Investments in and net advances to subsidiaries	454,100
Deferred debt issuance costs	<u>33,300</u>
Total assets	<u>\$ 786,700</u>

LIABILITIES AND STOCKHOLDERS' DEFICIT

Current liabilities:	
Prepetition liabilities subject to compromise, net of discount of \$9,500	\$ 1,410,000
Postpetition liabilities	<u>14,700</u>
Total current liabilities	1,424,700
Deferred gain resulting from deconsolidation of subsidiary	<u>55,300</u>
Total liabilities	1,480,000
Commitments and contingencies	
Stockholders' deficit:	
Preferred stock, \$0.001 par value; 5,000,000 shares authorized; no shares issued and outstanding	—
Common Stock, \$0.001 par value; 590,000,000 shares authorized; 177,818,753 shares issued and outstanding	200
Common Stock — Class B, \$0.001 par value; 10,000,000 shares authorized; no shares issued and outstanding	—
Additional paid-in capital	1,512,200
Deferred stock-based compensation	(400)
Accumulated other comprehensive income (loss)	(2,300)
Accumulated deficit	<u>(2,203,000)</u>
Total stockholders' deficit	<u>(693,300)</u>
Total liabilities and stockholders' deficit	<u>\$ 786,700</u>

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

CONDENSED STATEMENTS OF OPERATIONS

For the Period Ended September 30, 2001

(Unaudited)

	<u>Three Months</u>	<u>Nine Months</u>
Other income (expense):		
Interest income.....	\$ 3,700	\$ 20,500
Realized gain on short-term investments	—	6,100
Other than temporary losses on short-term investments	—	(1,300)
Other expenses	(200)	(500)
Equity in losses of subsidiaries	(121,000)	(442,000)
Interest expense (Contractual interest expense was \$36,200 and \$110,400 for the three and nine months ended September 30, 2001, respectively)	(18,300)	(92,600)
Reorganization expenses, net	<u>(3,900)</u>	<u>(3,900)</u>
Other income (expense), net	<u>(139,700)</u>	<u>(513,700)</u>
Net loss	<u>\$ (139,700)</u>	<u>\$ (513,700)</u>
Basic and diluted net loss per common share	<u>\$ (0.79)</u>	<u>\$ (2.94)</u>
Weighted average common shares used in computing basic and diluted per share amounts	<u>176,829,127</u>	<u>174,507,085</u>

CONDENSED STATEMENT OF CASH FLOWS

For the Nine Months Ended September 30, 2001

(Unaudited)

Operating Activities:	
Net loss	\$(513,700)
Adjustments to reconcile net loss to net cash used in operating activities:	
Amortization of deferred stock-based compensation	1,400
Accretion of interest on investments	(6,500)
Accretion of debt discount and amortization of deferred debt issuance costs ...	21,000
Realized gain on short-term investments	(6,100)
Other than temporary losses on short-term investments	1,300
Equity in losses of subsidiaries	442,000
Net changes in operating assets and liabilities:	
Prepetition accounts payable and accrued liabilities subject to compromise ..	(7,600)
Postpetition accounts payable and accrued liabilities	14,700
Other liabilities	<u>(2,700)</u>
Net cash used in operating activities	(56,200)
Investing Activities:	
Purchase of short-term investments	(442,100)
Maturities of short-term investments	434,800

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Sale of short-term investments	329,800
Purchase of restricted investments in connection with the bankruptcy proceeding	(257,200)
Advances to subsidiary and affiliated undertakings	<u>(541,500)</u>
Net cash used in investing activities	(476,200)
Financing Activities:	
Proceeds from common stock issuance	<u>3,900</u>
Net cash provided by financing activities	<u>3,900</u>
Net decrease in cash and cash equivalents	(528,500)
Cash and cash equivalents at beginning of period	<u>556,500</u>
Cash and cash equivalents at end of period	<u>\$ 28,000</u>

Operating cash receipts and payments made by Covad resulting from the Plan are as follows for the period of August 15, 2001 through September 30, 2001:

Cash receipts:	
Interest received	\$600
Total cash receipts	<u>\$600</u>
Cash disbursements:	
Interest paid	\$100
Total cash disbursements	<u>\$100</u>

As of September 30, 2001, the Plan had not been confirmed by the Bankruptcy Court. Accordingly, all unsecured, prepetition obligations that had not been approved for payment by the Bankruptcy Court were segregated in the Company's condensed consolidated balance sheet as of September 30, 2001 as "Prepetition liabilities subject to compromise."

As of September 30, 2001, Covad's prepetition liabilities subject to compromise consisted of the following:

Long-term debt (net of discount of \$9,500)	\$1,342,000
Accrued interest	40,900
Accrued market development funds and customer incentives	15,000
Unearned revenue and other	5,000
Accounts payable	1,300
Accrued collocation and network service fees	1,200
Other accrued liabilities	<u>4,600</u>
Total	<u>\$1,410,000</u>

As of September 30, 2001, since the Plan had not been confirmed and no claims had been allowed by the Bankruptcy Court, Covad's prepetition liabilities subject to compromise were reported at their historical amounts in the Company's condensed consolidated balance sheet as of September 30, 2001 in accordance with AICPA Statement of Position ("SOP") 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code."

Furthermore, for financial reporting purposes, the Company was required to recognize interest expense during the Chapter 11 proceedings only to the extent that it would be paid during the proceedings or it was

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

probable that it would be an allowed claim. Accordingly, the Company did not recognize interest expense on its long-term obligations that were subject to compromise. For the three and nine months ended September 30, 2001, the Company's reported interest expense was \$18,300 and \$92,600, respectively. For the three and nine months ended September 30, 2001, the Company's contractual interest expense was \$36,169 and \$110,415, respectively.

As of September 30, 2001, Covad's postpetition liabilities consisted of the following:

Accrued collocation and network service fees	\$ 5,000
Accounts payable	4,100
Other accrued liabilities	<u>5,600</u>
Total	<u>\$14,700</u>

All other liabilities reflected in the Company's condensed consolidated balance sheet as of September 30, 2001 represent liabilities that were not subject to compromise as a result of the Plan.

In accordance with SOP 90-7, expenses resulting from the restructuring are reported separately as reorganization items. For the three and nine months ended September 30, 2001, the Company recognized expenses directly associated with Covad's Chapter 11 bankruptcy proceeding in the amount of \$4,100 (none during the three and nine months ended September 30, 2002). These reorganization expenses consisted primarily of professional fees for legal and financial advisory services. In addition, for the three and nine months ended September 30, 2001, the Company recognized interest income in the amount of \$204 on accumulated cash that Covad did not disburse as a result of its Chapter 11 reorganization proceedings (none during the three and nine months ended September 30, 2002). Such interest income has been offset against the aforementioned reorganization expenses in the Company's condensed consolidated statements of operations for the three and nine months ended September 30, 2001.

There were unresolved claims related to Covad's Chapter 11 bankruptcy proceedings aggregating \$31,608 and \$10,959 as of December 31, 2001 and September 30, 2002, respectively. The Company has recorded these unresolved claims in its condensed consolidated balance sheets based on the amount of such claims allowed by the Bankruptcy Court (adjusted for changes in the value of the Company's common stock after December 20, 2001), unless the Company has persuasive evidence indicating that a claim is duplicative with another allowed claim that was settled previously or is otherwise in error. In these cases, the unresolved claim does not meet the criteria for recognition in the Company's condensed consolidated financial statements. However, it is reasonably possible that the Company's unresolved Chapter 11 bankruptcy claims could ultimately be settled for amounts that differ from the aggregate liability for "Unresolved claims related to bankruptcy proceedings" reflected in the accompanying condensed consolidated balance sheet as of September 30, 2002.

As of December 31, 2001 and September 30, 2002, the Company (i) held \$8,000 and \$500, respectively, of cash in a reserve fund, classified as "Restricted cash and investments" in the accompanying condensed consolidated balance sheets, and (ii) had reserved 7,295,844 and 6,528,733 shares of common stock, respectively, pending the resolution of the aforementioned unresolved claims.

7. Other Restructuring Activities

BlueStar Communications Group, Inc. and its subsidiaries (collectively, "BlueStar"), which were acquired by the Company on September 22, 2000 in a transaction accounted for as a purchase, provided broadband communications and Internet services to small and medium sized businesses in smaller cities using a direct sales model. Continued losses at BlueStar, with no near term possibility of improvement, caused the Company's board of directors to decide to cease the Company's funding of BlueStar's operations on June 22, 2001. Subsequently, on June 25, 2001, BlueStar terminated all of its 365 employees. However, 59 of

COVAD COMMUNICATIONS GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

BlueStar's former employees were temporarily retained by the Company for varying periods through July 31, 2001 to assist with the migration of certain BlueStar end user lines to the Company's network, as described below. In addition, the Company hired 69 of BlueStar's former employees after June 25, 2001.

On June 24, 2001, the Company and BlueStar entered into a Purchase Agreement ("PA") under which the Company has purchased the right to offer service to BlueStar's customers, subject to BlueStar's right to seek higher offers. The Company paid approximately \$2,000 in 2001 under the PA and has no additional liabilities under the PA as of September 30, 2002. To facilitate the migration of BlueStar's customers, the Company and BlueStar entered into a Migration Agreement on July 12, 2001 that required the Company to pay certain amounts contemplated in the PA directly to certain former employees of BlueStar and certain BlueStar vendors, including the Assignee, as defined below. The Company made payments aggregating approximately \$700 and \$5,100 in connection with BlueStar's cessation of operations during the three and nine months ended September 30, 2001, respectively. Of this aggregate amount, approximately \$1,300 represented employee severance benefits, approximately \$2,000 represented customer acquisition costs under the PA and approximately \$1,800 represented legal and other professional fees relating to the liquidation of BlueStar, as described below. Such (i) severance benefits and professional fees and (ii) customer acquisition costs were charged to (i) restructuring expenses and (ii) network and product costs, respectively, in the Company's condensed consolidated statement of operations for the three and nine months ended September 30, 2001.

On June 25, 2001, BlueStar made an irrevocable assignment for the benefit of creditors ("ABC") of all its assets to an independent trustee (the "Assignee") in the State of Tennessee. Immediately thereafter, the Assignee began an orderly liquidation of BlueStar that was initially expected to be completed in the fourth quarter of 2002. However, the Assignee has informed the Company that it is still in the process of resolving some matters among BlueStar's creditors and that the process may extend into the second half of 2003.

An ABC under Tennessee law is a non-judicial alternative to a plan of liquidation under Chapter 7 of the Bankruptcy Code. As a result of the ABC, BlueStar's former assets are no longer controlled by BlueStar or the Company and cannot be used by either BlueStar's or the Company's board of directors to satisfy the liabilities of BlueStar. Consequently, the liquidation of BlueStar's assets and the discharging of its liabilities are currently under the sole control of the Assignee and the control of BlueStar's assets no longer rests with the Company. Therefore, the Company deconsolidated BlueStar effective June 25, 2001, which resulted in the recognition of a deferred gain in the amount of \$55,200 in the Company's condensed consolidated balance sheets as of September 30, 2002 and December 31, 2001. Such deferred gain represents the difference between the carrying values of BlueStar's assets (aggregating approximately \$7,900) and liabilities (aggregating approximately \$63,100) as of June 25, 2001. The Company will recognize such deferred gain in its statement of operations when the liquidation of BlueStar is complete and its liabilities have been discharged.

Under the terms of the acquisition agreement dated September 22, 2000, up to 5.0 million additional shares of the Company's common stock were to be issued to BlueStar's former stockholders if BlueStar achieved certain specified levels of revenues and earnings before interest, taxes, depreciation and amortization in 2001. However, during April 2001, the Company reached an agreement with the BlueStar stockholders' representative to resolve this matter, as well as the matters that caused 0.8 million of the Company's common shares to be held in escrow as of December 31, 2000, by providing the BlueStar stockholders with 3.25 million of the 5.0 million shares, in exchange for a release of claims against the Company. The 0.8 million common shares were ultimately returned to the Company under this agreement. These transactions were approved by more than 80% of BlueStar's stockholders on June 27, 2001. BlueStar's former stockholders received the additional shares of the Company's common stock subsequent to June 30, 2001. Consequently, the Company recorded an estimated liability in the amount of \$2,230 through a charge to goodwill during the three months ended June 30, 2001. However, the Company determined that such goodwill was impaired based on BlueStar's continued operating losses, as described above. Therefore, such goodwill balance was written-off through a charge to operations of \$2,230 during the three months ended June 30, 2001, which was

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

subsequently reduced by \$241 during the three months ended September 30, 2002 due to a revision of the initial estimate.

During the fourth quarter of 2000, the Company announced a comprehensive restructuring plan that involved the following steps:

- raising revenue by reducing rebates and other incentives that the Company provides to customers and reducing new line addition plans for 2001 to improve margins and reduce subscriber payback times;
- closing approximately 200 under-performing or not fully built-out central offices and reducing the size of the Company's network to approximately 1,700 central offices;
- reducing the Company's workforce by 638 employees, which represented approximately 21% of the Company's workforce;
- closing a facility in Alpharetta, Georgia and consolidating offices in Manassas, Virginia, Santa Clara, California and Denver, Colorado.
- continued downsizing of the Company's international operations and discontinuing plans to fund additional international expansion while continuing to manage existing investments;
- enhancing productivity in the Company's operations to increase customer satisfaction while reducing costs;
- restructuring the Company's direct sales and marketing channel; and
- evaluating and implementing other cost reduction strategies, including salary freezes and reductions in travel, facilities and advertising expenses.

In connection with this restructuring plan, the Company recorded a charge to operations of \$4,988 in the fourth quarter of 2000 relating to employee severance benefits that met the requirements for accrual as of December 31, 2000. During the three months ended September 30, 2001, the Company reduced its workforce by three employees and paid severance benefits of \$200, which were charged against the restructuring liability recorded as of December 31, 2000. For the nine months ended September 30, 2001, the total workforce was reduced by 638 employees and the Company paid \$4,000 in severance benefits, which were charged against the restructuring liability recorded as of December 31, 2000.

The Company recorded additional restructuring expenses aggregating \$14,805 and \$1,000 during the first and second quarters of 2001, respectively. These expenses consisted principally of collocation and building lease termination costs that met the requirements for accrual during these periods. No additional restructuring expenses were recorded by the Company during the three months ended September 30, 2001. During the three and nine months ended September 30, 2001, the Company paid collocation and building lease termination costs of \$400 and \$4,900, respectively, which were charged against the restructuring liabilities recorded during the first and second quarters of 2001. The Company completed the restructuring activities that were initiated in 2000 during the fourth quarter of 2001. Therefore, the Company neither recognized nor paid any restructuring expenses during the three and nine months ended September 30, 2002. However, management continues to consider whether additional restructuring is necessary, and additional charges to operations related to any further restructuring activities may be incurred in future periods.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

8. Contingencies

Litigation

As described in Note 6, on December 13, 2001, the Bankruptcy Court entered an order confirming the Plan and, on December 20, 2001, the Plan was consummated and the Company emerged from bankruptcy. Under the Plan, the Company settled several claims against it. These claims include:

- The class action lawsuits filed in the United States District Court for the Northern District of California, provided that this settlement will not be final unless it is approved by that court. This settlement is described in more detail below.
- The lawsuits filed in the Superior Court of the State of California for the County of Santa Clara by six purchasers of the convertible notes that the Company issued in September 2000.
- Disputed claims made by former shareholders of Laser Link.net.
- Disputed claims made by GE Capital and its subsidiary, Heller Financial Group.

Purchasers of the Company's common stock and purchasers of the convertible senior notes the Company issued in September 2000 filed complaints on behalf of themselves and alleged classes of stockholders and holders of convertible notes against the Company and certain present and former officers of the Company in the United States District Court for the Northern District of California (the "District Court"). The complaints have been consolidated and the lead plaintiff filed its amended consolidated complaint. The amended consolidated complaint alleges violations of federal securities laws on behalf of persons who purchased or otherwise acquired the Company's securities, including common stock and notes, during the period from April 19, 2000 to May 24, 2001. The relief sought includes monetary damages and equitable relief. On August 10, 2001, the Company signed an MOU with counsel for the lead plaintiffs in this litigation that tentatively resolves the litigation. Under this agreement, the Company is to contribute 6,495,844 common shares to the settlement. The Company's insurance carriers would fund the cash portion of the settlement. This settlement was approved by the Bankruptcy Court on December 20, 2001. Final settlement is contingent on the additional approval by the District Court, which preliminarily approved the settlement on October 29, 2002. Additionally, the Company, based on the advice of legal counsel, believes it is more likely than not that this settlement will ultimately be approved by the District Court. Consequently, the Company recorded a liability of approximately \$4,000 in its condensed consolidated balance sheet as of June 30, 2001 through a charge to litigation-related expenses for the three months then ended in connection with this anticipated settlement. As a result of changes in the fair market value of the Company's common stock, the Company decreased this liability to \$2,400 as of September 30, 2001 through a credit to litigation-related expenses in the amount of \$1,600 for the three months then ended, increased this liability to \$18,578 as of December 31, 2001 through a charge to litigation-related expenses in the amount of \$16,178 for the three months then ended and decreased this liability to \$9,549 as of September 30, 2002 through charges (credits) to litigation-related expenses in the amount of \$1,884 and \$(9,029) for the three and nine months ended September 30, 2002, respectively. The Company will continue to remeasure this liability in future periods, based on changes in the underlying value of the Company's common stock until this litigation is resolved.

Several stockholders have filed complaints in the United States District Court for the Southern District of New York, on behalf of themselves and purported classes of stockholders, against the Company and several former and current officers and directors in addition to some of the underwriters who handled the Company's stock offerings. These lawsuits are so-called IPO allocation cases, challenging practices allegedly used by certain underwriters of public equity offerings during the late 1990s and 2000. On April 19, 2002, the plaintiffs amended their complaint and removed the Company as a defendant. Certain directors and officers are still named in the complaint. The plaintiffs claim that the Company and others failed to disclose the arrangements that some of these underwriters purportedly made with certain investors. The Company believes it has strong

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

defenses to these lawsuits and intends to contest them vigorously. However, because these lawsuits are at an early stage, the Company is unable to provide an evaluation of the ultimate outcome of the litigation.

In September 2000, a manufacturer of telecommunications hardware filed a complaint against the Company in the United States District Court for the District of Arizona, alleging claims for false designation of origin, infringement and unfair competition. The plaintiff is seeking an injunction to stop the Company from using the COVAD trademark, as well as an award of monetary damages. The Company does not believe these claims have any merit, but the outcome of this litigation cannot presently be determined.

In April 1999, the Company filed a lawsuit against Bell Atlantic (now Verizon) and its affiliates in the United States District Court for the District of Columbia. The Company is pursuing antitrust and other claims in this lawsuit arising out of Verizon's conduct as a supplier of network facilities, including central office space, transmission facilities and telephone lines. The Company also filed a lawsuit against BellSouth Telecommunications and its subsidiaries in the United States District Court for the Northern District of Georgia. The Company is pursuing antitrust and other claims in this lawsuit similar to its claims against Verizon. Both courts have dismissed some of the Company's claims on the basis of the ruling of the Seventh Circuit in *Goldwasser v. Ameritech*. The court in the Verizon case also dismissed the Company's remaining claims on other grounds. The Company voluntarily dismissed its remaining claims in the BellSouth case so it could pursue certain issues on appeal. The Company has appealed these rulings to the Eleventh Circuit Court of Appeals and the Court of Appeals for the District of Columbia. On August 2, 2002, the Eleventh Circuit Court of Appeals reversed the lower court's decision in the BellSouth case and remanded the case for further proceedings. BellSouth has requested a rehearing before the Eleventh Circuit and that request is still pending. The Company cannot predict the outcome of these matters.

On June 11, 2001, Verizon Communications filed a lawsuit against the Company in the United States District Court for the Northern District of California. Verizon is a supplier of telephone lines that the Company uses to provide its services to its customers. The complaint claims that the Company falsified trouble ticket reports with respect to the phone lines that the Company ordered and seeks unspecified monetary damages and injunctive relief. The current complaint asserts causes of action for negligent and intentional misrepresentation and violations of California's unfair competition statute. This lawsuit is at an early stage, so the Company is unable to provide an evaluation of the ultimate outcome.

An unfavorable outcome in any of the pending legal proceedings described above could have a material adverse effect on the Company's consolidated financial position and results of operations.

The Company is also a party to a variety of other legal proceedings, as either plaintiff or defendant, and is engaged in other disputes that arise in the ordinary course of its business. The Company believes these other matters will be resolved without a material adverse effect on the its consolidated financial position and results of operations, other than the fees and expenses necessary to defend these actions.

Other Contingencies

On May 24, 2002, the United States Court of Appeals for the District of Columbia vacated the Federal Communications Commission's ("FCC") decision granting Competitive Local Exchange Carriers like the Company the ability to purchase line-shared services from the traditional telephone companies. The Court of Appeals remanded the matter to the FCC and it is unclear when the FCC will issue a new order concerning line-sharing. The FCC and the Company filed a Motion for Reconsideration and a request to stay vacature of the line sharing order with the Court of Appeals pending the FCC's review of the line sharing order. On September 4, 2002, the Court of Appeal denied the FCC's and the Company's Motion for Reconsideration, but granted the request to stay vacature of the line sharing order until January 2, 2003. The Company therefore has the continued right to line sharing until at least January 2, 2003. Management also believes that the Company has a continued right to line-sharing under its interconnection agreements with the traditional

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

telephone companies, but those agreements do allow the traditional telephone companies to renegotiate their terms based on a change in law. If the traditional telephone companies invoke this change-in-law provision, or if the FCC does not issue a new order allowing the Company to purchase line-shared services, it is possible that the traditional telephone companies could either refuse to sell the Company such services or could substantially increase the cost of line-shared services, either of which would have a material adverse effect on the Company and could even result in a liquidation or sale of the Company. The court also remanded the list of unbundled network elements that had been developed by the FCC. The FCC is in the process of reviewing the list of unbundled network elements, which include the transmission facilities and telephone lines that the Company purchases from the traditional telephone companies in order to provide services to its customers. If the FCC removes any of the Company's existing transmission facilities or telephone lines from the previous list of unbundled network elements, the traditional telephone companies could either increase the cost of obtaining such transmission facilities and telephone lines or deny the Company access entirely, which would adversely affect the Company.

As of September 30, 2002, the Company had disputes with a number of telecommunications companies concerning the balances owed to such carriers for collocation fees and certain network services. The Company believes that such disputes will be resolved without a material adverse effect on its consolidated financial position and results of operations. However, it is reasonably possible that the Company's estimates of its collocation fee and network service obligations, as reflected in the accompanying condensed consolidated balance sheets, could change in the near term, and the effects could be material to the Company's consolidated financial position and results of operations. In this regard, in May 2002, the Company executed a settlement agreement with a telecommunications company involving certain disputed network service obligations. Under the terms of this settlement agreement, the Company was relieved of a network service obligation with a recorded balance of \$6,018 through a combination of a \$468 payment and a \$5,550 credit that reduced network and product costs during the three months ended June 30, 2002 (none during the three months ended September 30, 2002).

In addition, the Company is engaged in a variety of negotiations, arbitrations and regulatory and court proceedings with several traditional telephone companies. These negotiations, arbitrations and proceedings concern the traditional telephone companies' denial of physical central office space to the Company in certain central offices, the cost and delivery of transmission facilities and telephone lines and central office spaces, billing issues and other operational issues. Other than the payment of legal fees and expenses, which are not quantifiable but are expected to be material, the Company does not believe that these matters will result in material liability to the Company and the potential gains are not quantifiable at this time. However, an unfavorable outcome in any of these negotiations, arbitrations and regulatory proceedings could have a material adverse effect on the Company's consolidated financial position and results of operations if it is denied or charged higher rates for transmission lines or central office spaces.

As of September 30, 2002, the Company was analyzing the applicability of certain transaction-based taxes to sales of its products and services. This analysis includes discussions with authorities of significant jurisdictions in which the Company does business to determine the extent of its respective transaction-based tax liabilities. It is the Company's opinion that such analysis will be concluded without a material adverse effect on its consolidated financial position and results of operations. However, it is reasonably possible that the Company's estimates of its transaction-based tax liabilities, as reflected in the accompanying condensed consolidated balance sheets, could change in the near term, and the effects could be material to the Company's consolidated financial position and results of operations.

9. Business Segments

The Company disaggregates its business operations based upon differences in services and marketing channels, even though the cash flows from these operations are not independent of each other. The Company's

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

wholesale division (“Wholesale”) is a provider of high-speed connectivity services, including DSL, T-1 and VPN services, to ISP, enterprise and telecommunications carrier customers. The Company’s direct division (“Direct”) is a provider of high-speed connectivity, Internet access and other services to individuals, small and medium-sized businesses, and other organizations. Corporate operations represent general corporate expenses, headquarters facilities and equipment, investments, and other non-recurring and unusual items not allocated to the segments.

The Company evaluates performance of the segments based on segment operating results, excluding nonrecurring and unusual items.

Set forth below is additional information about the Company’s business segments as of and for the three and nine months ended September 30, 2002 and 2001 (the Company’s 2001 segment information has been restated to conform to the Company’s organizational structure in 2002):

<u>As of and for the Three Months Ended September 30, 2002:</u>	<u>Wholesale</u>	<u>Direct</u>	<u>Total Segments</u>	<u>Corporate Operations</u>	<u>Intercompany Eliminations</u>	<u>Consolidated Total</u>
Domestic revenues from unaffiliated customers, net	\$ 82,324	\$ 13,882	\$ 96,206	\$ —	\$ —	\$ 96,206
Net loss	\$ (22,672)	\$ (10,526)	\$ (33,198)	\$ (18,509)	\$ —	\$ (51,707)
Assets	\$ 481,923	\$ 13,054	\$ 494,977	\$ 7,834	\$ —	\$ 502,811
<u>As of and for the Three Months Ended September 30, 2001:</u>	<u>Wholesale</u>	<u>Direct</u>	<u>Total Segments</u>	<u>Corporate Operations</u>	<u>Intercompany Eliminations</u>	<u>Consolidated Total</u>
Domestic revenues from unaffiliated customers, net	\$ 75,842	\$ 8,942	\$ 84,784	\$ —	\$ —	\$ 84,784
Net loss	\$ (109,571)	\$ (2,859)	\$ (112,430)	\$ (27,319)	\$ —	\$ (139,749)
Assets	\$ 933,354	\$ (228)	\$ 933,126	\$ 23,815	\$ —	\$ 956,941
<u>As of and for the Nine Months Ended September 30, 2002:</u>	<u>Wholesale</u>	<u>Direct</u>	<u>Total Segments</u>	<u>Corporate Operations</u>	<u>Intercompany Eliminations</u>	<u>Consolidated Total</u>
Domestic revenues from unaffiliated customers, net	\$ 254,253	\$ 41,352	\$ 295,605	\$ —	\$ —	\$ 295,605
Net loss	\$ (86,070)	\$ (14,813)	\$ (100,883)	\$ (48,456)	\$ —	\$ (149,339)
<u>As of and for the Nine Months Ended September 30, 2001:</u>	<u>Wholesale</u>	<u>Direct</u>	<u>Total Segments</u>	<u>Corporate Operations</u>	<u>Intercompany Eliminations</u>	<u>Consolidated Total</u>
Domestic revenues from unaffiliated customers, net	\$ 206,364	\$ 36,764	\$ 243,128	\$ —	\$ —	\$ 243,128
Net loss	\$ (343,307)	\$ (53,822)	\$ (397,129)	\$ (116,617)	\$ —	\$ (513,746)

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

The following discussion of our financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the related notes thereto included elsewhere in this Report on Form 10-Q and the audited consolidated financial statements and notes thereto and management's discussion and analysis of financial condition and results of operations for the year ended December 31, 2001 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 29, 2002. This discussion contains forward-looking statements, the accuracy of which is subject to risks and uncertainties. Our actual results could differ materially from those expressed in forward-looking statements for many reasons including, but not limited to, those discussed herein and in the "Risk Factors" section of our Annual Report on Form 10-K, which is contained in Part I, Item 1, Business-Risk Factors, of that report. We disclaim any obligation to update information contained in any forward-looking statement. See "— Forward Looking Statements."

(All dollar amounts are presented in thousands, except per share amounts)

Overview

We are a leading provider of high-speed Internet connectivity ("broadband") and related communications services, which we sell to businesses and consumers indirectly through Internet service providers ("ISP"), telecommunications carriers and other resellers. These wholesale partners generally sell our services to their business and consumer end-users. We also sell our services directly to business and consumer end-users through our field sales force, telephone sales and our website. Our services include a range of high-speed, high-capacity Internet access connectivity and related services using digital subscriber line ("DSL"), T-1, Virtual Private Network ("VPN") and firewall technologies.

We have a relatively short operating history. We introduced our services commercially in the San Francisco Bay Area in December 1997. As of September 30, 2002, we believe we have one of the largest nationally deployed DSL networks based on approximately 1,750 operational central offices that pass more than 40 million homes and businesses in the U.S. As of September 30, 2002, we had approximately 359,000 high-speed Internet access lines in service using DSL technology (approximately 9.0% of these lines are associated with wholesale customers for which we recognize revenue on a cash basis due to their financial condition, primarily concentrated among two such customers). We have received orders for our services from more than 140 ISP and telecommunications carrier customers, including AT&T Corporation, Sprint Corporation, SBC Communications, Earthlink, Inc., XO Communications and UUNET Technologies (a WorldCom company), as well as Megapath Networks and Speakeasy.net, both privately owned companies. We also provide dial-up Internet access service to over 55,000 customers through our direct sales channel. We are also developing a variety of services that are enhanced or enabled by our high-speed network.

Since our inception, we have generated significant net losses and we continue to experience negative operating cash flow. As of September 30, 2002, we had an accumulated deficit of \$1,493,847. We expect losses and negative cash flow to continue at least into 2004. Although we currently have a plan in place that we believe will ultimately allow us to achieve positive cash flows from our operating activities without raising additional capital, our cash reserves are limited and our plan is based on assumptions, some of which are out of our immediate control. If our assumptions are not met, we may need to raise additional capital on terms that are less favorable than we desire, which may have a material adverse effect on our financial condition and could cause significant dilution to our shareholders. The inability to raise additional capital could also result in a liquidation or sale of our company.

In the course of preparing our financial statements for the year ended December 31, 2000, internal control weaknesses were discovered, some of which continued into 2001 and 2002. The improvements we have made over the last several quarters to our internal policies and procedures and systems capabilities have significantly improved controls. However, as discussed in Part I, Item 4, we have identified some control weaknesses associated with certain operational tracking procedures for our network assets. Based on controls that have

been recently developed and implemented as well as other planned enhancements, we do not expect any material adjustments in a subsequent period related to this control issue.

Recent Developments

On September 23, 2002, we announced that we signed a three-year agreement with AT&T Corp. that provides it with the ability to purchase certain of our wholesale consumer-grade broadband Internet access services. Covad expects AT&T to begin placing orders for these services in the fourth quarter of 2002.

On September 23, 2002, we launched the "Popularizing Broadband" marketing campaign to educate consumers and businesses about the benefits of broadband. The national campaign includes programs, promotions and an advertising campaign to educate consumers about the benefits of broadband. It also includes lower prices for our tiered consumer-grade DSL services.

On September 5, 2002, we announced that we signed a five-year agreement with America Online, Inc. ("AOL") that provides them with the ability to purchase our wholesale DSL services. Covad expects AOL to begin placing orders for our services in the fourth quarter of 2002.

In conjunction with the execution of the AOL agreement, we granted AOL three warrants to purchase an aggregate of 3,500,000 shares of our common stock at prices of \$1.06, \$3.00 and \$5.00 per share. Such warrants were immediately exercisable, fully vested and non-forfeitable at the date of grant. Accordingly, the measurement date for accounting purposes for the warrants was the date of grant. The aggregate fair value of such warrants of approximately \$3,800 was recorded as a deferred customer incentive and will be recognized as a reduction of revenues on a straight-line basis over the five-year term of the agreement because we believe that future revenues from AOL will exceed the fair value of the warrants. However, because the agreement with AOL contains no minimum purchase commitment and is cancelable under certain circumstances by AOL, we will continue to monitor the recoverability of the deferred customer incentive balance described above in periods ending after September 30, 2002.

On July 29, 2002, we announced that we signed a two year agreement with Sprint Corporation that provides them with the ability to purchase our wholesale DSL services. Sprint Corporation began placing orders for our services in August of 2002. The agreement does not contain any volume or revenue commitments by Sprint Corporation.

Effective October 16, 2002, Chuck Haas terminated his employment with Covad as our Executive Vice President and General Manager, Covad Wholesale. Mr. Haas will continue to serve the Company in an advisory role.

On July 25, 2002, we announced that Andrew S. Lockwood was appointed as our senior vice president of marketing. Mr. Lockwood will be responsible for driving demand for our consumer and business class services. He will also lead our branding efforts, advertising, and overall marketing direction, which includes product marketing and development, marketing communications and strategic planning.

We also recently added two new members to our Board of Directors: Richard A. Jalkut and L. Dale Crandall. Mr. Crandall was also appointed chairman of the Audit Committee of our Board of Directors. Richard Shapero has resigned as a member of our Board of Directors.

Restructuring Activities

On November 13, 2001, we announced the signing of a loan agreement and the restructuring of our resale and marketing agreement with SBC Communications Inc. ("SBC"). We expect that the cash generated from these agreements will enable us to fully fund our operations until we generate positive cash flows from our operating activities. The agreements included four elements: a one-time \$75,000 prepayment, collateralized by substantially all of our domestic assets, that SBC can use toward the purchase of our services during the next 10 years; a \$50,000 four-year loan collateralized by substantially all of our domestic assets; a payment to us of a \$10,000 restructuring fee in exchange for eliminating SBC's revenue commitments under the original resale and marketing agreement and the elimination of a \$15,000 co-op marketing fee owed by us to SBC under the

previous resale and marketing agreement. We received these funds on December 20, 2001. Under these agreements, upon a change of control, we are required to repay any outstanding principal and interest on the loan and any unused portion of the prepayment. In addition, under these agreements, SBC may accelerate any unpaid portion of the prepayment and the loan in the event that we default.

On August 15, 2001 (the "Petition Date"), we filed a voluntary petition (the "Petition") under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code") as contemplated by, and to implement, the agreements we entered into with the holders of our then-outstanding debt securities (the "Noteholders"), and to restructure various of our financial obligations. The Petition was filed with the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") and was assigned Case No. 01-10167 (JJF). Our operating subsidiaries did not commence bankruptcy proceedings and continued to operate in the ordinary course of business. We filed our First Amended Plan of Reorganization, as modified on November 26, 2001 (the "Plan"). On December 13, 2001, the Bankruptcy Court entered an order confirming the Plan and, on December 20, 2001 (the "Effective Date"), the Plan was consummated and we emerged from bankruptcy. However, the Bankruptcy Court still maintains jurisdiction over certain administrative matters related to the implementation of the Plan, including certain unresolved claims. Under our Plan, we were able to extinguish approximately \$1,394,020 in aggregate face amount of outstanding debt securities, including accrued interest, in exchange for a combination of approximately \$271,708 in cash and 35,292,800 common shares, or 15% of the reorganized company. We also recorded an extraordinary gain on the extinguishment of debt in the amount of \$1,033,727 in the fourth quarter of 2001.

On June 25, 2001, our former subsidiary, BlueStar, made an irrevocable assignment for the benefit of its creditors ("ABC") of all its assets to an independent trustee (the "Assignee") in the state of Tennessee. Immediately thereafter, the Assignee began an orderly liquidation of BlueStar that was initially expected to be completed in the fourth quarter of 2002. However, the Assignee has informed the Company that it is still in the process of resolving some matters among BlueStar's creditors and that the process may extend into the second half of 2003. An ABC under Tennessee law is a non-judicial alternative to a plan of liquidation under Chapter 7 of the United States Bankruptcy Code. As a result of the ABC, BlueStar's former assets are no longer controlled by us or BlueStar and cannot be used by either BlueStar's or our board of directors to satisfy the liabilities of BlueStar. Consequently, the liquidation of BlueStar's assets and the discharging of its liabilities are currently under the sole control of the Assignee. Therefore, we deconsolidated BlueStar effective June 25, 2001, which resulted in the recognition of a deferred gain in the amount of approximately \$55,200 in our condensed consolidated balance sheet as of September 30, 2002. Such deferred gain represents the difference between the carrying values of BlueStar's assets (aggregating approximately \$7,900) and liabilities (aggregating approximately \$63,100) as of June 25, 2001. We will recognize such deferred gain in our consolidated statement of operations when the liquidation of BlueStar is complete and its liabilities have been discharged.

During the year ended December 31, 2000, in response to changes in the economy and the capital markets, we implemented a business plan that helped to lower our cost structure in an effort to reach profitability earlier than previously planned. Specific steps we took included: the BlueStar subsidiary ABC; elimination of our high yield bond debt through a reorganization under the Bankruptcy Code; reduction of our workforce by as many as 2,600 employees from a peak of approximately 4,000 employees in 2000; reduction of the size of our network to approximately 1,700 central offices; reevaluating the amount and quantity of rebates and other incentives that we provide to our customers; consolidation and/or closing of administrative offices throughout the United States; enhancement of productivity in our operations to increase customer satisfaction while reducing costs; streamlining our direct sales and marketing channel and supplementing it with telephone sales and sales through our website; and evaluation and implementation of other cost reduction strategies, including reductions in travel and facilities expenditures.

Revenue Recognition and Change in Accounting Principle

During the fourth quarter of 2000, we changed our method of accounting for up-front fees associated with service activation and the related incremental direct costs in accordance with SEC Staff Accounting Bulletin ("SAB") No. 101, "Revenue Recognition in Financial Statements." Previously, we had recognized up-front

fees as revenues upon activation of service. Under the new accounting method, which was adopted retroactive to January 1, 2000, we now recognize up-front fees associated with service activation over the expected term of the customer relationship, which is presently estimated to be 24 months, using the straight-line method. Also as a result of the adoption of SAB No. 101, retroactive to January 1, 2000, we now treat the incremental direct costs of service activation, which consist principally of customer premises equipment, service activation fees paid to other telecommunications companies, service delivery and sales commissions, as deferred charges in amounts that are no greater than the up-front fees that are deferred, and such deferred incremental direct costs are amortized to expense using the straight-line method over 24 months.

The cumulative effect of the change in accounting principle resulted in a charge to operations of \$9,249, which was included in our net loss for the year ended December 31, 2000. For the three and nine months ended September 30, 2001, we recognized approximately \$2,697 and \$10,640, respectively, in revenue that was included in the cumulative effect adjustment as of January 1, 2000 (none during the three and nine months ended September 30, 2002). The effect of that revenue during the three and nine months ended September 30, 2001 was to decrease our net loss by \$688 and \$2,777, respectively. Although SAB 101 substantially alters the timing of recognition of certain revenues and treatment of certain costs in our consolidated financial statements, it does not affect our consolidated cash flows.

Internet Service Provider and Telecommunications Carrier Difficulties

In order to limit our exposure to the potential financial difficulties of some of our wholesale partners, we have implemented certain policies and taken a series of actions. We may stop taking new orders from these partners but continue to install and maintain previously accepted orders. We may terminate our contracts with those partners who are unresponsive to our efforts to maintain an on-going business relationship. While our goal is to maintain consistent high quality service to end-users, we may also decide to disconnect some end-users that are purchasing our services from customers facing financial difficulties and, in some cases, we may attempt to migrate these end users to another wholesale partner or to our own Covad Direct service. Although we have successfully migrated end-users, there can be no assurance that these migrated end-users will continue to purchase our services. Even if we are able to migrate end-users, this process requires a significant amount of our resources, which may impair our ability to install new lines as they are ordered. Any of these circumstances could adversely affect our business. We have also worked proactively to collect outstanding amounts billed to these customers.

Even though we are making progress in reducing the number of subscribers for which we are not currently recognizing revenue on an accrual basis, we may be unable to completely restore the remaining lines to normal revenue producing status and we may encounter future payment problems with our customers. In addition, in light of the financial position of many ISPs and certain telecommunications carriers, should a particular ISP or telecommunications carrier customer become subject to reorganization or bankruptcy proceedings, we may be unable to collect payments owed to us or retain payments or other consideration (including subscriber lines) already received by us.

Related Party Transactions

Our Vice-Chairman and former interim chief executive officer, Frank Marshall, who is also a member of our board of directors, was a minority stockholder and former member of the board of directors of one of our former ISP customers, InternetConnect, which filed for bankruptcy protection in 2001. We recognized revenues of \$2,569 and \$3,623 related to this customer during the three and nine months ended September 30, 2001, respectively (none during the three and nine months ended September 30, 2002). Gross accounts receivable from this customer amounted to \$7,301 as of September 30, 2001 (none at September 30, 2002). On January 3, 2002, we purchased substantially all of the assets of InternetConnect in an auction supervised by the United States Bankruptcy Court for the Central District of California. The purchase price for the assets of InternetConnect was \$5,470 in cash. Under the terms of the asset purchase agreement, we may be required to pay additional cash of up to \$1,880 for the assets of InternetConnect, depending upon the outcome of a previous post-petition bankruptcy claim filed by us against InternetConnect. Such claim is still unresolved. We did not assume any liabilities or obligations of InternetConnect or hire any of InternetConnect's employees.

The tangible assets purchased from InternetConnect consisted of accounts receivable, refundable deposits and property and equipment. We also purchased the right, but not the obligation, to assume InternetConnect's customer contracts. However, we did not exercise this right. Instead, we solicited approximately 9,250 DSL, T-1, VPN and dial-up customers of InternetConnect, and approximately 6,200 of such customers executed new contracts with us and our resellers subsequent to January 3, 2002.

We acquired an equity interest in a supplier during 1999 and disposed of this interest in 2001. Purchases from this supplier totaled \$1,596 and \$4,009 for the three and nine months ended September 30, 2002, respectively, and \$1,142 and \$19,160 for the three and nine months ended September 30, 2001, respectively. We also purchased certain products from a company in which our vice-chairman and former interim chief executive officer, Frank Marshall, serves as a director. Purchases from this vendor totaled \$52 and \$109 during the three and nine months ended September 30, 2002, respectively, and \$0 and \$21 for the three and nine months ended September 30, 2001, respectively.

Results of Operations

We regard our business as being operated in two distinct segments based upon differences in services and marketing channels even though the cash flows from these segments are not independent of each other. Our wholesale division ("Wholesale") is a provider of high-speed connectivity services, which include DSL technology, to ISP, enterprise and telecommunications carrier customers. Our direct division ("Direct"), is a provider of Internet access services to individuals, corporations, small businesses and other organizations. We evaluate performance of the segments based on segment operating results.

Three and Nine Months Ended September 30, 2002 and 2001

Revenues, net

We recorded net revenues of \$96,206 for the three months ended September 30, 2002, an increase of \$11,422, or 13.5%, over net revenues of \$84,784 for the three months ended September 30, 2001. We recorded net revenues of \$295,605 for the nine months ended September 30, 2002, an increase of \$52,477, or 21.6%, over net revenues of \$243,128 for the nine months ended September 30, 2001. As described in the overview section above, we deconsolidated our BlueStar subsidiary effective June 25, 2001. Net revenues from BlueStar were \$11,977 during the nine months ended September 30, 2001 (none during the three months ended September 30, 2001 or the three and nine months ended September 30, 2002). The increase in revenues for the nine months ended September 30, 2002, as compared to the nine months ended September 30, 2001, is mainly attributable to growth in the number of customers and end-users. Revenues for the three months ended September 30, 2002 decreased by 1.6%, as compared to the three months ended June 30, 2002. The decrease was caused by lower selling prices, promotional rebates and our continuing high end user disconnection rate during the three months ended September 30, 2002. Although we expect our subscriber base to grow, lower selling prices, promotional rebates and the loss of end users may continue to impair our ability to increase our revenues. During the three months ended September 30, 2002, we recognized revenues of \$1,010 from one of our wholesale partners resulting from the short fall in their contractual revenue commitment. In addition, as a result of developments in the bankruptcy proceedings of one of our wholesale customers, as discussed further below, we recognized revenues of \$1,120 during the three months ended September 30, 2002 that were deferred as of December 31, 2001.

Included in net revenues are Federal Universal Service Fund charges billed to our customers aggregating \$1,861 and \$7,757 for the three and nine months ended September 30, 2002, respectively, and \$2,967 and \$10,094 for the three and nine months ended September 30, 2001, respectively.

We recorded net revenues of \$82,324 from our Wholesale channel and \$13,882 from our Direct channel for the three months ended September 30, 2002, an increase of \$6,482, or 8.5%, and \$4,940, or 55.2%, over net revenues of \$75,842 and \$8,942 for the three months ended September 30, 2001, respectively. We recorded net revenues of \$254,253 from our Wholesale channel and \$41,352 from our Direct channel for the nine months ended September 30, 2002, an increase of \$47,889, or 23.2%, and \$4,588, or 12.5%, over revenues of \$206,364 and \$36,764 for the nine months ended September 30, 2001, respectively.

We have over 140 wholesale customers. However, for the three and nine months ended September 30, 2002, our 30 largest wholesale customers collectively comprised 93.6% and 93.4%, respectively, of our total wholesale net revenues and 80.1% and 80.3%, respectively, of our total net revenues. As of September 30, 2002, receivables from these customers collectively comprised 81.9% of our gross accounts receivable balance. For the three and nine months ended September 30, 2001, our 30 largest wholesale customers collectively comprised 90.6% and 82.6%, respectively, of our total wholesale net revenues and 81.0% and 74.1%, respectively, of our total net revenues. As of September 30, 2001, receivables from these customers collectively comprised 86.2% of our gross accounts receivable balance.

For the three months ended September 30, 2002, two wholesale customers (Earthlink, Inc. and AT&T Internet Services) individually accounted for 20.7% and 10.0%, respectively, of our total net revenues. For the nine months ended September 30, 2002, these wholesale customers individually accounted for 20.5% and 9.2%, respectively, of our total revenues. As of September 30, 2002, receivables from these wholesale customer's individually accounted for 39.3% and 8.2%, respectively, of our gross accounts receivable balance.

For the three months ended September 30, 2001, two wholesale customers (Earthlink, Inc. and XO Communications) individually accounted for 17.8% and 10.9%, respectively, of our total net revenues. For the nine months ended September 30, 2001, these wholesale customers individually accounted for 16.8% and 10.8%, respectively, of our total net revenues. As of September 30, 2001, receivables from these wholesale customers comprised 16.9% 16.5%, respectively, of our gross accounts receivable balance.

A number of our customers are currently in bankruptcy proceedings. Revenues from these customers accounted for approximately 18.9% and 19.6% of our total net revenues for the three and nine months ended September 30, 2002, respectively, and 17.7% and 20.4% of our total net revenues for the three and nine months ended September 30, 2001, respectively. Although WorldCom filed for bankruptcy protection during the three months ended September 30, 2002, we continued to recognize revenues from WorldCom on an accrual basis based on the revenue recognition criteria described in Note 2. Consequently, the disclosures in the following paragraph exclude amounts pertaining to WorldCom because we have not presently classified them as financially distressed. We continue to attempt to migrate end users from certain of these financially distressed customers to the extent it is legally and operationally feasible.

During the three and nine months ended September 30, 2002, we issued billings to our financially distressed customers, including those that have filed for bankruptcy protection (excluding WorldCom, as noted above), aggregating \$7,447 and \$39,779, respectively, that were not recognized as revenues or accounts receivable in our condensed consolidated financial statements, as compared to the corresponding amounts of \$15,317 and \$52,636 for the three and nine months ended September 30, 2001, respectively. However, we ultimately recognized revenues from certain of these customers on a cash basis aggregating \$12,077 and \$43,446 during the three and nine months ended September 30, 2002, respectively, and \$5,839 and \$15,715 during the three and nine months ended September 30, 2001, respectively, some of which relates to services provided in prior periods. In addition, revenues recognized during the three months ended March 31, 2002 include payments totaling \$3,307 from certain bankrupt customers that we received prior to January 1, 2002 and recorded as unearned revenues in our consolidated balance sheet as of December 31, 2001 because our ability to retain these payments was not reasonably assured as of that date. However, as a result of subsequent developments in the bankruptcy proceedings of such customers, we determined that our ability to retain these payments was reasonably assured prior to March 31, 2002. Consequently, we recognized these payments as revenues during the three months then ended. No such payments were recognized as revenues during the three months ended June 30, 2002. However, during the three months ended September 30, 2002, due to the developments in the bankruptcy proceeding of another customer, we determined our ability to retain certain payments received from this bankrupt customer prior to January 1, 2002 was now reasonably assured. Accordingly, we recognized revenues of \$1,120 that were deferred as of December 31, 2001. We had contractual receivables from our financially distressed customers, including receivables of \$6,026 from customers that have filed for bankruptcy protection (excluding WorldCom, as noted above), totaling \$6,250 as of September 30, 2002 that are not reflected in our condensed consolidated financial statements.

We have obtained information indicating that some of our customers, including WorldCom, who (i) were essentially current in their payments for our services prior to September 30, 2002, or (ii) have subsequently paid all or significant portions of the respective amounts that we recorded as accounts receivable as of September 30, 2002, may become financially distressed. Revenues from these customers accounted for approximately 25.6% and 25.1% of our total net revenues for the three and nine months ended September 30, 2002, respectively. As of September 30, 2002, receivables from these customers comprised 28.6% of our gross accounts receivable balance. If these customers are unable to demonstrate their ability to pay for our services in a timely manner, in periods ending subsequent to September 30, 2002, revenue from these customers will be recognized on a cash basis as described above.

We have obtained persuasive evidence indicating that the financial condition of one of our customers, which was designated as financially distressed in 2000, improved significantly during the three months ended June 30, 2002, principally as a result of a capital infusion during this period. Consequently, we concluded that collection of our billings to this customer was now reasonably assured. Therefore, we resumed the recognition of revenues from this customer on an accrual basis during the second quarter of 2002, which resulted in the recognition of a receivable balance and revenues in the amount of approximately \$1,542 as of and for the three months ended June 30, 2002 that relate to services rendered in periods ended prior to April 1, 2002. We collected such receivable balance in full during July 2002. No similar amounts were recognized during the other periods reported in the accompanying condensed consolidated financial statements.

We have billing disputes with certain of our customers. These disputes arise in the ordinary course of business in the telecommunications industry and their impact on our accounts receivable and revenues can be reasonably estimated based on historical experience. Accordingly, we maintain an allowance, through charges to revenues (which amounted to \$540 and \$2,130 during the three and nine months ended September 30, 2002, respectively, and \$1,293 and \$9,253 during the three and nine months ended September 30, 2001, respectively), based on our estimate of the ultimate resolution of these disputes.

Network and Product Costs

We recorded network and product costs of \$68,112 for the three months ended September 30, 2002, a decrease of \$35,178, or 34.1%, over network and product costs of \$103,290 for the three months ended September 30, 2001. For the three months ended September 30, 2002, network and product costs were 70.8% of net revenues, a significant improvement from the three months ended September 30, 2001, when network and product costs were 121.8% of net revenues. We recorded network and product costs of \$231,576 for the nine months ended September 30, 2002, a decrease of \$128,320, or 35.7%, over network and product costs of \$359,896 for the nine months ended September 30, 2001. For the nine months ended September 30, 2002, network and product costs were 78.3% of net revenues, a significant improvement from the nine months ended September 30, 2001, when network and product costs were 148.0% of net revenues. The decrease in network and product costs, in absolute dollars and as a percentage of revenues, during the three and nine months ended September 30, 2002 is primarily attributable to the downsizing of our network from historical levels, cost reduction efforts to lower network costs related to data transport, lower costs in customer premise equipment, a reduction in headcount within our operations and engineering groups and the deconsolidation of our BlueStar subsidiary effective June 25, 2001 (network and product costs related to BlueStar were \$34,768 during the nine months ended September 30, 2001 and none during the three months ended September 30, 2001 or three and nine months ended September 30, 2002), offset by increased costs resulting from a larger subscriber base.

Network and product costs for the three months ended June 30, 2002 include a credit of \$5,550 from the settlement of certain disputed network service obligations during the quarter. Network and product costs for the three months ended March 31, 2002 include acquisition costs of \$3,674 associated with certain of InternetConnect's former customers, as described above (none during the three months ended June 30, 2002 or September 30, 2002). We expect network and product costs to increase in future periods if we can increase sales activity and grow revenue, but to decrease as a percentage of revenue as we leverage the economies of scale that we expect.

As discussed below in "Part II, Item 1, Legal Proceedings", there is uncertainty concerning our ability to purchase line-shared services from the traditional telephone companies as a result of a decision issued by the United States Court of Appeals for the District of Columbia on May 24, 2002 and the ongoing Triennial Review and other regulatory proceedings at the FCC. As a result of those legal and regulatory proceedings, it is possible that the traditional telephone companies could either refuse to sell us line-shared services or could substantially increase the cost of line-shared services, which could substantially increase our network costs for line-shared services and could cause us to discontinue our consumer grade services for new and existing customers.

Sales, Marketing, General and Administrative Expenses

Sales, marketing, general and administrative expenses consist primarily of salaries, expenses for the development of business and our promotional and advertising expenses and expenses attributable to our management team. Sales, marketing, general and administrative expenses were \$42,607 for the three months ended September 30, 2002, a decrease of \$3,994, or 8.6%, over sales, marketing, general and administrative expenses of \$46,601 for the three months ended September 30, 2001. For the three months ended September 30, 2002, sales, marketing, general and administrative expenses were 44.3% of net revenues, an improvement from the three months ended September 30, 2001, when these expenses were 55.0% of net revenues. Sales, marketing, general and administrative expenses were \$116,636 for the nine months ended September 30, 2002, a decrease of \$52,060, or 30.9%, over sales, marketing, general and administrative expenses of \$168,696 for the nine months ended September 30, 2001. For the nine months ended September 30, 2002, sales, marketing, general and administrative expenses were 39.5% of net revenues, an improvement from the nine months ended September 30, 2001, when these expenses were 69.4% of net revenues. The decrease in expenses from 2001 to 2002 is attributable to a reduction in our workforce, a reduction in office space throughout the United States, reduced travel by employees and the deconsolidation of our BlueStar subsidiary effective June 25, 2001 (sales, marketing, general and administrative expenses related to BlueStar were \$11,510 during nine months ended September 30, 2001 and none during the three months ended September 30, 2001 or the three and nine months ended September 30, 2002).

Sales, marketing, general and administrative expenses for the three months ended September 30, 2002 increased by \$7,215, or 20.4%, over the three months ended June 30, 2002. The increase was primarily attributable to our radio, television and other various media marketing and advertising programs related to our "Popularizing Broadband" campaign. We expect sales, marketing, general and administrative expense levels to increase in the near future as we continue our marketing efforts.

Total operating expenses, which include network and product costs, sales, marketing, general and administrative expenses, depreciation and amortization, restructuring expenses, impairment of long-lived assets and litigation-related expenses, were \$148,070 and \$443,367 for the three and nine months ended September 30, 2002, respectively. These expenses for the three and nine months ended September 30, 2002 were comprised of \$105,416 and \$338,877, respectively, from our Wholesale channel, \$24,094 and \$57,306, respectively, from our Direct channel and \$18,560 and \$47,184 respectively, from our Corporate Operations.

Provision for Bad Debts

We recorded net bad debt recoveries of \$1,731 for the three months ended September 30, 2002, as compared to bad debt expense of \$3,572 for the three months ended September 30, 2001. Bad debt expense (recoveries) was (1.8%) and 4.2% of net revenues for the three months ended September 30, 2002 and 2001, respectively. We recorded net bad debt expense of \$312 for the nine months ended September 30, 2002, as compared to \$523 for the nine months ended September 30, 2001. The decrease in the amount of bad debt expense is the result of improved collection of outstanding receivables. In addition, as a result of developments in the bankruptcy proceedings of one of our customers during the three months ended September 30, 2002, we recognized bad debt recoveries of \$2,491.

Depreciation and Amortization

Depreciation and amortization of property and equipment was \$33,498 and \$92,882 for the three and nine months ended September 30, 2002, respectively, and \$36,092 and \$103,796 for the three and nine months ended September 30, 2001, respectively. The decrease in 2002 was due principally to asset retirements and certain assets becoming fully depreciated during this period, offset by additional depreciation expense of \$9,584 recognized during the three months ended September 30, 2002, as discussed further below. We expect depreciation and amortization to decrease because we anticipate that our capital expenditures in the near term will be less than historical amounts. We believe that the geographic footprint of our network will remain relatively unchanged and that near term capital expenditures will be mostly limited to adding capacity to our network to support new users.

Amortization expenses associated with collocation fees were \$3,700 and \$10,990 for the three and nine months ended September 30, 2002, respectively, and \$1,763 and \$9,333 for the three and nine months ended September 30, 2001, respectively. The increase in 2002 resulted from the suspension of our network build during 2000 and 2001 and the resumption of our network build for selected markets during the last 15 months. We do not expect to incur significant capital expenditures in connection with this expansion.

Effective January 1, 2001, we reduced the remaining estimated useful lives of all long-lived assets, excluding building and leasehold improvements, that previously had estimated useful lives in excess of five years such that the residual balances and any subsequent additions are now depreciated or amortized over five years. This change in accounting estimate increased our net loss by \$2,900 (\$0.02 per share) and \$9,200 (\$0.05 per share) during the three and nine months ended September 30, 2001, respectively.

As part of the continuing evaluation of our network assets during the three months ended September 30, 2002, certain matters were identified related to prior financial reporting periods that necessitated the recording of additional expenses. Such matters were related to (i) changes in our network configuration, which necessitated reductions of the remaining estimated useful lives of certain network equipment and (ii) the capitalization of certain network and product costs that should have been charged to operating expenses. Accordingly, for the three months ended September 30, 2002, we have recorded (i) additional depreciation expense of \$9,584 and (ii) additional network and product costs of \$1,215. We do not believe these amounts are material to the periods in which they should have been recorded, nor do we expect that the expenses will be material to our consolidated operating results for the year ending December 31, 2002. However, if these adjustments are ultimately deemed to be material to our consolidated operating results for the year ending December 31, 2002, we will need to restate prior financial reporting periods, including the current period. The impact on prior financial reporting periods would be as follows: net loss for the three months ended June 30, 2002 would be increased by \$1,292 (\$0.01 per share), net loss for the three months ended March 31, 2002 would be increased by \$1,099 (\$0.01 per share), net income for the year ended December 31, 2001 would be decreased by \$8,057 (\$0.04 per share) and net loss for the year ended December 31, 2000 would be increased by \$351 (\$0.00 per share).

Depreciation and amortization expenses for the three and nine months ended September 30, 2002 were \$37,198 and \$103,872, respectively, and were comprised of \$35,979 and \$99,702, respectively, from our Wholesale channel, \$420 and \$1,419, respectively, from our Direct channel, and \$799 and \$2,751, respectively, from our Corporate Operations.

Restructuring Expenses

In connection with the restructuring plan we announced in December 2000, we recorded a charge to operations of \$4,988 during the fourth quarter of 2000 relating to employee severance benefits that met the requirements for accrual as of December 31, 2000.

Results of operations for the nine months ended September 30, 2001 include restructuring expenses of \$17,617 for severance benefits, professional fees and collocation and building lease termination costs that met the requirements for accrual during these periods, including severance benefits and professional fees associated with the deconsolidation of our BlueStar subsidiary on June 25, 2001 as discussed above. No additional

restructuring expenses were recognized for the three months ended September 30, 2001. However, we paid severance benefits of approximately \$200 and \$4,000 during the three and nine months ended September 30, 2001, respectively, which were charged against the restructuring liability. We completed the restructuring activities that were initiated in 2000 during the fourth quarter of 2001. Therefore, we neither recognized nor paid any restructuring expenses during the three or nine months ended September 30, 2002. However, we continue to consider whether additional restructuring is necessary, and we may incur additional expenses related to further restructuring activities in future periods.

Reorganization Expenses

For the three and nine months ended September 30, 2001, we recognized net reorganization expenses directly associated with our Chapter 11 proceeding of \$3,896 (none during the three and nine months ended September 30, 2002) in accordance with AICPA Statement of Position ("SOP") 90-7, "Financial Reporting by Entities in Reorganization Under the Bankruptcy Code," which requires that expenses resulting from the reorganization of a business in a bankruptcy proceeding be reported separately as reorganization items. For the three and nine months ended September 30, 2001, we recognized expenses associated with our reorganization in the amount of \$4,105 (none during the three and nine months ended September 30, 2002). These expenses consisted primarily of legal and financial advisory services. In addition, SOP 90-7 requires that interest income earned by an entity in a bankruptcy proceeding that would not have been earned but for the proceedings be reported as a reorganization item. For the three and nine months ended September 30, 2001, we recognized interest income in the amount of \$209 (none during the three and nine months ended September 30, 2002) on accumulated cash that we did not disburse as a result of the bankruptcy proceedings.

Long-Lived Asset Impairment

During the nine months ended September 30, 2001, we recorded a charge of \$1,989 relating to the write-off of certain goodwill associated with our BlueStar subsidiary. There were no similar charges during the three months ended September 30, 2001, during which period \$241 of previously recorded charges were reversed, or the three and nine months ended September 30, 2002.

Litigation-related Expenses

We recorded charges (credits) to litigation-related expenses of \$1,884 and \$(9,029) for the three and nine months ended September 30, 2002, respectively, and \$1,907 and \$5,907 for the three and nine months ended September 30, 2001, respectively. The charges (credits) for the three and nine months ended September 30, 2002 represent non-cash valuation adjustments for the change in value of the 6,495,844 shares of common stock that are expected to be distributed upon the approval of an MOU as described in "Part II. Item 1. Legal Proceedings". We will adjust this charge in subsequent quarters based on changes in our stock price until such time the settlement is finalized. The charge for the three and nine months ended September 30, 2001 includes charges (credits) of \$(1,600) and 2,400, respectively, resulting from the initial measurement of such MOU and subsequent non-cash valuation adjustments, as described above, as well as a cash payment of \$467 and a non-cash charge of \$3,040 related to tentative settlements reached by us with certain other plaintiffs during the three months ended September 30, 2001.

Net Interest Income (Expense)

Net interest income (expense) was \$184 and \$(53) for the three and nine months ended September 30, 2002, respectively, and \$(13,282) and \$(69,301) for the three and nine months ended September 30, 2001, respectively. Net interest income (expense) during the three and nine months ended September 30, 2002 consisted principally of interest expense on our long-term note payable to SBC, which is further described below, less interest income earned on our cash, cash equivalents and short-term investments balances. Net interest income (expense) during the three and nine months ended September 30, 2001 consisted primarily of interest expense on our senior notes, which were extinguished in December 2001, and capital lease obligations, less interest income on our cash, cash equivalents and short-term investments balances.

For the three and nine months ended September 30, 2001, as required by SOP 90-7, we recognized interest expense only to the extent that it would be paid during the bankruptcy proceedings or it was probable that it would be an allowed priority, secured or unsecured claim. The reported interest expense as well as the contractual interest expense for the three and nine months ended September 30, 2001 are disclosed in the accompanying condensed consolidated statements of operations. In addition, as described above, interest income earned as a result of the bankruptcy proceedings for the three and nine months ended September 30, 2001 amounted to \$209 (none during the three and nine months ended September 30, 2002) and has been included as a reorganization item in the accompanying condensed consolidated statements of operations.

Upon our emergence from Chapter 11 bankruptcy on December 20, 2001, a series of new agreements with SBC became effective. One such agreement involves a long-term note payable with a principal amount of \$50,000 that is collateralized by substantially all of our domestic assets. This note accrues interest at 11.0% per annum, which is payable quarterly beginning in December 2003. The entire unpaid principal balance is payable in December 2005. However, we have the right to prepay the principal amount of the note, in whole or in part, at any time without penalty.

We expect future interest expense to be limited principally to interest on our 11.0% note payable to SBC. We may, however, seek additional debt financing in the future if it is available on terms that we believe are favorable. If we seek additional debt financing, our interest expense would increase.

Investment Gains and Losses

We recorded a net loss on investments for the three months ended September 30, 2002 of \$101 as a result of our equity in the losses of unconsolidated affiliates. For the nine months ended September 30, 2002, we recorded a net loss on investments of \$1,357. This included a net realized loss on the sale of certain investments in unconsolidated affiliates of \$636, our equity in the losses of unconsolidated affiliates of \$704 and a net realized loss on short-term investments of \$17.

We recorded a net loss on investments for the three months ended September 30, 2001 of \$14,403. This included a net realized gain on short-term investments of \$75, equity in the losses of unconsolidated affiliates of \$5,011 and a provision for the impairment of investments in unconsolidated affiliates of \$9,467. For the nine months ended September 30, 2001, we recorded a net loss on investments of \$16,314. This included equity in the losses of unconsolidated affiliates of \$11,626, the recognition of other than temporary losses on short-term investments of \$1,311 and a provision for the impairment of investments in unconsolidated affiliates of \$9,467, offset by a net realized gain on short-term investments of \$5,912 and a gain on disposal of investments in unconsolidated affiliates of \$178.

Income Taxes

We made no provision for income taxes because we operated at a loss during all periods presented.

Critical Accounting Policies and Estimates

Our discussion and analysis of financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. The preparation of our financial statements requires us to make estimates that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities. We base our accounting estimates on historical experience and other factors that are believed to be reasonable under the circumstances. However, actual results may vary from these estimates under different assumptions or conditions. The following is a summary of our critical accounting policies and estimates:

- We recognize revenues when (i) persuasive evidence of an arrangement between the customer and us exists, (ii) service has been provided to the customer, (iii) the price to the customer is fixed and determinable and (iv) collectibility of the sales price is reasonably assured. We recognize up-front fees

associated with service activation over the expected term of the customer relationship, which is presently estimated to be 24 months, using the straight-line method. Similarly, we treat the incremental direct costs of service activation (which consist principally of customer premise equipment, service activation fees paid to other telecommunications companies and sales commissions) as deferred charges in amounts no greater than the up-front fees that are deferred, and such incremental direct costs are amortized to expense using the straight-line method over 24 months.

- We have concentrations of credit risk with several customers, certain of which were experiencing financial difficulties as of September 30, 2002 and 2001 and were not current in their payments for our services as of those dates. Accordingly, we recognize revenues from certain of these financially distressed customers in the period in which cash is received, after the collection of all previous outstanding accounts receivable balances. We perform ongoing credit evaluations of our customers' financial condition and maintain an allowance for estimated credit losses. In addition, we have billing disputes with certain of our customers. These disputes arise in the ordinary course of business in the telecommunications industry and their impact on our accounts receivable and revenues can be reasonably estimated based on historical experience. We maintain an allowance, through charges to revenues, based on our estimate of the ultimate resolution of these disputes and our reported revenue in any period could be different than what is reported if we employed different assumptions in estimating the outcome of these disputes.
- We state our inventories at the lower of cost or market. In assessing the ultimate recoverability of inventories, we are required to make estimates regarding future customer demand.
- We implemented significant reorganization and restructuring plans in 2001 and 2000. In this regard, we consummated a plan of reorganization under Chapter 11 of the United States Bankruptcy Code on December 20, 2001. However, as of September 30, 2002, we had certain claims relating to our Chapter 11 bankruptcy proceedings that were unresolved. Therefore, it is reasonably possible that such unresolved bankruptcy claims could ultimately be settled for amounts that differ from the aggregate liability for such claims reflected in our condensed consolidated balance sheet as of September 30, 2002. In addition, we tentatively settled certain securities litigation in connection with our emergence from Chapter 11 bankruptcy in 2001. However, the final settlement of such litigation is still subject to court approval.
- Property and equipment and intangible assets are recorded at cost, subject to adjustments for impairment. Property and equipment and intangible assets are depreciated or amortized using the straight-line method over their estimated useful lives, certain of which were significantly revised in 2001. In assessing the recoverability of our property and equipment and intangible assets, we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates and assumptions change in the future, we may be required to record additional impairment charges relating to our property and equipment and intangible assets. See further discussion below concerning the recent adoption of SFAS Nos. 142 and 144 and our framework for evaluating the impairment of long-lived assets in periods ending after December 31, 2001.
- We are a party to a variety of legal proceedings, as either plaintiff or defendant, and are engaged in other disputes that arise in the ordinary course of business, including disputes with a number of telecommunications companies related to the balances we owe them for collocation and network service fees. We are required to assess the likelihood of any adverse judgments or outcomes to these matters, as well as potential ranges of probable losses for certain of these matters. The determination of the liabilities required, if any, for loss contingencies is made after careful analysis of each individual issue. However, it is reasonably possible that the liabilities reflected in our condensed consolidated balance sheets for loss contingencies and business disputes could change in the near term due to new developments, the effects of which could be material to our consolidated financial position and results of operations.
- We are currently analyzing the applicability of certain transaction-based taxes to sales of our products and services. This analysis includes discussions with authorities of jurisdictions in which we do business

to determine the extent of our transaction-based tax liabilities. We believe that such negotiations will be concluded without a material adverse effect on our consolidated financial position and results of operations. However, it is reasonably possible that our estimates of our transaction-based tax liabilities could change in the near term, the effects of which could be material to our consolidated financial position and results of operations.

- We account for income taxes using the liability method, under which deferred tax assets and liabilities are determined based on differences between the financial reporting and tax bases of our assets and liabilities. We record a valuation allowance on our deferred tax assets to arrive at an amount that is more likely than not to be realized. In the future, should we determine that we are able to realize all or part of our deferred tax assets, which presently are fully reserved, an adjustment to our deferred tax assets would increase income in the period in which the determination was made.

Recent Accounting Pronouncements

In July 2002, the Financial Accounting Standard Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 146, “Accounting for Costs Associated with an Exit or Disposal Activity.” SFAS No. 146 revises the accounting for exit and disposal activities under Emerging Issues Task Force (“EITF”) Issue 94-3, “Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)” by extending the period in which expenses related to restructuring activities are reported. A commitment to a plan to exit an activity or dispose of long-lived assets will no longer be sufficient to record a one-time charge for most restructuring activities. Instead, companies will record exit or disposal costs when they are incurred and can be measured at fair value. In addition, the resultant liabilities will be subsequently adjusted for changes in estimated cash flows. SFAS No. 146 is effective prospectively for exit or disposal activities initiated after December 31, 2002. Companies may not restate previously issued financial statements for the effect of the provisions of SFAS No. 146, and liabilities that a company previously recorded under EITF Issue 94-3 are grandfathered. We will adopt SFAS No. 146 on January 1, 2003, and we do not believe the adoption of SFAS No. 146 will have a material effect on our consolidated financial statements.

In April 2002, the FASB issued SFAS No. 145 “Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections.” SFAS No. 145 rescinds SFAS No. 4, “Reporting Gains and Losses from Extinguishment of Debt,” which required all gains and losses from extinguishment of debt to be aggregated and, if material, classified as an extraordinary item, net of related income tax effect. SFAS No. 145, which is effective in periods beginning after May 15, 2002 requires that gains or losses from extinguishment of debt be classified as extraordinary items only if they meet the criteria of APB Opinion No. 30. We are required to adopt the provisions of SFAS No. 145 on January 1, 2003, and we do not believe the adoption of SFAS No. 145 will have a material effect on our consolidated financial statements.

On January 1, 2002, we adopted SFAS No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets,” which supersedes SFAS No. 121, “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of,” and provides a single accounting model for long-lived assets to be disposed of. The adoption of SFAS No. 144 had no effect on our condensed consolidated financial statements.

On January 1, 2002, we adopted SFAS No. 141, “Business Combinations” and SFAS No. 142, “Goodwill and Other Intangibles Assets.” SFAS No. 141 eliminates the pooling-of-interests method of accounting for business combinations, except for qualifying business combinations that were initiated prior to July 1, 2001. Under SFAS No. 142, goodwill and indefinite-lived intangible assets are no longer amortized, but are reviewed annually for impairment, or more frequently if impairment indicators arise. The adoption of SFAS Nos. 141 and 142 had no effect on our condensed consolidated financial statements.

On January 1, 2002, we adopted the EITF guidance regarding the provision in EITF Issue 00-25, “Vendor Income Statement Characterization of Consideration from a Vendor to a Retailer,” dealing with consideration from a vendor to a reseller under cooperative advertising and other arrangements. This provision of EITF Issue 00-25 states that consideration from a vendor to a reseller of the vendor’s products or services is

presumed to be a reduction of the selling price of the vendor's products or services, unless the vendor (i) receives an identifiable benefit in return for the consideration and (ii) can reasonably estimate the fair value of the benefit received. If the amount of consideration paid by the vendor exceeds the estimated fair value of the benefit received, the excess amount is to be recorded by the vendor as a reduction of revenues. The adoption of this new guidance did not have a material effect on our condensed consolidated financial statements.

In August 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations." SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. We are required to adopt SFAS No. 143 on January 1, 2003, and we do not believe the adoption of SFAS No. 143 will have a material effect on our consolidated financial statements.

On January 1, 2001, we adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended. SFAS No. 133 standardizes the accounting for derivatives and hedging activities and requires that all derivatives be recognized in the statement of financial position as either assets or liabilities at fair value. Changes in the fair value of derivatives that do not meet the hedge accounting criteria are required to be reported in operations. The adoption of SFAS No. 133 had no effect on our condensed consolidated financial statements.

Liquidity and Capital Resources

Our operations have required substantial capital investment for the procurement, design and construction of our central office spaces, the design, creation, implementation and maintenance of our operational support system, the purchase of telecommunications equipment and the design and development of our networks. Capital expenditures were \$5,058 and \$14,286 for the three and nine months ending September 30, 2002, respectively. Capital expenditures increased during the three months ended September 30, 2002 as compared to the three months ended June 30, 2002 primarily due to expenditures related to recently signed wholesale agreements. We expect that our capital expenditures related to the purchase of infrastructure equipment necessary for the development and expansion of our networks and the development of new regions will be relatively flat in future periods while capital expenditures related to the addition of subscribers in existing regions will increase proportionately in relation to the number of new subscribers that we add.

From our inception through September 30, 2002, we financed our operations primarily through private placements of \$220,600 of equity securities, \$1,282,000 in net proceeds raised from the issuance of notes (including our recent agreement with SBC for a \$50,000 note payable), a \$75,000 collateralized deposit and \$719,000 in net proceeds raised from public equity offerings. As of September 30, 2002, we had an accumulated deficit of \$1,493,847, and unrestricted cash, cash equivalents, and short-term investments of \$228,207. In addition, we had stockholders' equity as of September 30, 2002 of \$119,840.

Net cash used in our operating activities was \$60,552 for the nine months ending September 30, 2002. The net cash used in our operating activities during this period was primarily due to the net loss of \$149,339, an increase in accounts receivable of \$9,459, a decrease in collateralized customer deposits of \$4,920, a decrease in unearned revenues of \$19,109 and a reduction of non-cash litigation-related expenses of \$9,029, offset by depreciation and amortization charges of \$103,872, a decrease in deferred costs of service activation of \$13,327, a decrease in restricted cash of \$8,703, and an increase in other current liabilities of \$8,417.

Net cash used in our investing activities was \$99,710 for the nine months ending September 30, 2002. The net cash used in our investing activities during this period was primarily due to purchases of short-term investments of \$213,681, and purchases of property and equipment of \$12,323, offset by maturities of short-term investments of \$70,988, sales of short-term investments of \$40,000, proceeds from sales of property and equipment of \$13,451 and proceeds from sales of investments in unconsolidated subsidiaries of \$3,360.

Net cash provided by our financing activities was \$1,572 for the nine months ending September 30, 2002. The net cash provided by our financing activities during this period was primarily due to proceeds from common stock issuances of \$1,583.

As of September 30, 2002, we had \$49,120 in unrestricted cash and cash equivalents and \$179,087 in unrestricted short-term investments. We expect to experience negative cash flow from operating and investing activities at least into 2004 due to continued development of new services and the addition of new end-users to our networks. Our future cash requirements for developing, deploying and enhancing our networks and operating our business, as well as our revenues, will depend on a number of factors including:

- the rate at which customers and end-users purchase and pay for our services and the pricing of such services;
- the financial condition of our customers;
- the level of marketing required to acquire and retain customers and to maintain a competitive position in the marketplace;
- the rate at which we invest in engineering, development and intellectual property with respect to existing and future technology;
- the operational costs that we incur to install, maintain and repair end-user lines and our network as a whole;
- pending litigation;
- regulatory developments;
- existing and future technology;
- unanticipated opportunities;
- network development schedules and associated costs; and
- the number of regions entered, the timing of entry and services offered.

In addition, we may wish to selectively pursue possible acquisitions of, or investments in, businesses, technologies or products complementary to ours in order to expand our geographic presence, broaden our product and service offerings and achieve operating efficiencies. We may not have sufficient liquidity, or we may be unable to obtain additional financing on favorable terms or at all, in order to finance such an acquisition or investment.

Our contractual debt and lease obligations as of December 31, 2001 for the next five fiscal years, and thereafter, were as follows:

	<u>2002</u>	<u>2003-2004</u>	<u>2005-2006</u>	<u>Thereafter</u>	<u>Total</u>
Note payable to SBC	\$ —	\$ —	\$50,000	\$ —	\$50,000
Capital leases	11	—	—	—	11
Office leases	5,540	9,226	5,742	1,829	22,337
Other operating leases	<u>2,371</u>	<u>1,575</u>	<u>5</u>	<u>—</u>	<u>3,951</u>
	<u>\$7,922</u>	<u>\$10,801</u>	<u>\$55,747</u>	<u>\$1,829</u>	<u>\$76,299</u>

We lease certain vehicles, equipment and office facilities under noncancelable operating leases that expire at various dates through 2009. The facility leases generally require us to pay operating costs, including property taxes, insurance and maintenance, and contain scheduled rent increases and certain other rent escalation clauses. Rent expense is reflected in our consolidated financial statements on a straight-line basis over the terms of the respective leases. We were also obligated under a capital equipment lease, which expired during 2002.

Our business plan includes certain discretionary spending that is predicated on certain revenue growth assumptions. If necessary, we will curtail this discretionary spending so that we can continue as a going concern at least through January 1, 2003 using only our unrestricted cash, cash equivalent and short-term investment balances in existence as of December 31, 2001. Additionally, based on the advice of our legal counsel, we believe it is more likely than not that certain securities litigation described in Note 8 to our September 30, 2002 condensed consolidated financial statements will ultimately be settled in accordance with the terms of the MOU dated August 10, 2001 executed by us and the plaintiffs in such securities litigation. Therefore, we do not believe that the ultimate settlement of this securities litigation will have a material adverse effect on our ability to continue as a going concern at least through January 1, 2003. However, in the event (1) the MOU is not ultimately approved by the United States District Court and/or (2) the settlement of the aforementioned securities litigation ultimately requires us to disburse additional cash, we will reduce discretionary spending so that we can continue as a going concern at least through January 1, 2003 using only our unrestricted cash, cash equivalent and short-term investment balances in existence as of December 31, 2001. We do not believe the curtailment of our discretionary spending, if necessary, will have a material adverse effect on the overall execution of our business plan.

We believe that our current cash, cash equivalents and short-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures until we generate positive cash flows from our operating activities, which we currently anticipate will be in 2004. An adverse business, legal, regulatory or legislative development may require us to raise additional financing or to change our business plan. We also recognize that we may be required to raise additional capital, the amount and timing of which is uncertain considering current capital market conditions. If we are unable to acquire additional capital or are required to raise it on terms that are unfavorable, it will have a material adverse effect on our financial condition, which could require a restructuring, sale or liquidation of our company.

Risk Factors

The following is a summary list of some of the risk factors relating to our Company. For additional detail regarding these and other risk factors, please refer to "Part I. Item 1. Business — Risk Factors" found in our 2001 Annual Report on Form 10-K, which was filed with the SEC on March 29, 2002.

- We may not be able to expand as quickly as we need to achieve profitability.
- We are dependent on a limited number of customers for the preponderance of our revenues, and we are highly dependent on sales through our resellers.
- We may experience decreasing margins on the sale of our services, which may impair our ability to achieve profitability or positive cash flow.
- The markets we face are highly competitive and we may not be able to compete effectively, especially against established industry competitors with significantly greater financial resources.
- Charges for unbundled network elements are generally outside of our control because they are proposed by the traditional telephone companies and are subject to costly regulatory approval processes.
- We may lose the ability to purchase line-shared services from the traditional telephone companies.
- We may be unable to obtain access on acceptable terms to remote terminals and other facilities that provide services to end users who are not served by a standard copper phone line from a central office where we can obtain collocation space.
- Our services are subject to government regulation, and changes in current or future laws or regulations and the methods of enforcing the laws and regulations could adversely affect our business.
- Our business will suffer if our interconnection agreements are not renewed or if they are modified on unfavorable terms.

- We may not be able to obtain space for our equipment on premises owned by the traditional local telephone companies on terms that are economical to our business.
- We cannot predict whether we will be successful because our business strategy is largely unproven.
- Our business is difficult to evaluate because we have a limited operating history.
- We have a history of losses and expect losses in the future.
- We are a party to litigation, and adverse results of such litigation could negatively impact our financial condition and results of operations.
- Our business may suffer unless financial market conditions improve.
- The financial uncertainty of the competitive telecommunications industry may continue to cause us to lose orders for our services.
- We may need to raise additional capital under difficult financial market conditions in order to maintain our operations.
- Our internal controls need to be improved.
- We have experienced increased order cancellations and end-user disconnections.
- We were delisted from the Nasdaq National Market and this limits the public market for our common stock.
- The price of our common stock may fluctuate significantly, which may result in losses for investors.
- Future sales or issuances of our common stock may depress our stock price.
- Anti-takeover effects of certain charter and bylaw provisions, Delaware law, our indebtedness, our Stockholder Protection Rights Plan and our compensation arrangements could prevent a change in our control.
- Our operating results are likely to fluctuate in future periods and may fail to meet the expectations of securities analysts and investors.
- Our success depends on our retention of certain key personnel, our ability to hire additional key personnel and the maintenance of good labor relations.
- We depend on a limited number of third parties for equipment supply, service and installation.
- We have made and may make acquisitions of complementary technologies or businesses in the future, which may disrupt our business and be dilutive to our existing stockholders.
- The broadband communications industry is undergoing rapid technological changes and new technologies may be superior to the technology we use.
- A failure of our network could delay or interrupt service to our customers.
- A breach of network security could delay or interrupt service to our customers.
- Interference in the traditional telephone companies' copper plant could degrade the performance of our services.
- Our intellectual property protection may be inadequate to protect our proprietary rights.
- We must comply with federal, state and local tax and other surcharges on our service, the levels of which are uncertain.

Forward-Looking Statements

We include certain estimates, projections, and other forward-looking statements in our reports, in presentations to analysts and others, and in other publicly available material. Expected or projected future

performance cannot be ensured. Actual results may differ materially from those in forward-looking statements due to a number of factors, including those referred to above under Risk Factors. The statements contained in this Report on Form 10-Q that are not historical facts are “forward-looking statements” (as such term is defined in Section 27A of the Securities Act and Section 21E of the Exchange Act), which can be identified by the use of forward-looking terminology such as “estimates,” “projects,” “anticipates,” “expects,” “intends,” “believes,” “is likely,” “is probable,” “is possible,” or the negative thereof or other variations thereon or comparable terminology, or by discussions of facts, events or strategies that involve risks and uncertainties. Examples of such forward-looking statements include but are not limited to:

- expectations regarding our ability to become cash-flow positive;
- expectations regarding the extent to which customers roll out our service;
- expectations regarding our relationships with our strategic partners and other potential third parties;
- expectations as to pricing for our services in the future;
- expectations as to the impact of our service offerings on our margins;
- the possibility that we may obtain significantly increased sales volumes;
- the impact of advertising on brand recognition and operating results;
- plans to make strategic investments and acquisitions and the effect of such investments and acquisitions;
- estimates and expectations of future operating results, including expectations regarding when we anticipate operating on a cash flow positive basis, the adequacy of our cash reserves, our monthly cash usage and the number of installed lines;
- expectations regarding the time frames, rates, terms and conditions for utilizing “line sharing”;
- plans to develop and commercialize value-added services;
- our anticipated capital expenditures;
- plans to enter into business arrangements with broadband-related service providers;
- expectations regarding the development and commencement of our voice services;
- our plans to expand our existing networks or to commence service in new metropolitan statistical areas;
- estimates regarding the timing of launching our service in new metropolitan statistical areas;
- the effect of regulatory reform and litigation; and
- other statements contained in this Report on Form 10-Q regarding matters that are not historical facts.

We disclaim any obligation to update information contained in any forward-looking statement

Item 3. *Market Risk*

Quantitative and Qualitative Disclosures about Market Risk

Our exposure to financial market risk, including changes in interest and marketable equity security prices, relates primarily to our investment portfolio and outstanding debt obligations. We typically do not attempt to reduce or eliminate our market exposure on our investment securities because a substantial majority of our investments are in fixed-rate, short-term securities. We do not have any derivative instruments. The fair value of our investment portfolio or related income would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due mainly to the fixed-rate, short-term nature of the substantial majority of our investment portfolio. In addition, all of our outstanding indebtedness as of September 30, 2002 is fixed-rate debt.

Item 4. Controls and Procedures

The Securities and Exchange Commission defines the term "disclosure controls and procedures" to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Our chief executive officer and our chief financial officer, based on their evaluation of the effectiveness of our "disclosure controls and procedures" within 90 days before the filing date of this quarterly report, have concluded that our disclosure controls and procedures were effective for this purpose, with the exception of controls related to certain network assets as described below.

As part of the continuing evaluation of our network assets during the three months ended September 30, 2002, we recorded additional depreciation expense of \$9,584 related to equipment that was deployed in the network and subsequently replaced as a result of a change in technology. Due to a deficiency in our internal controls related to certain operational procedures for tracking network assets which prevented this matter from being recognized for accounting purposes in a timely manner, the depreciable life of these assets was not adjusted to their remaining economic useful life in prior periods. To address these matters, we have implemented additional operational controls and systems capabilities to track network assets more precisely as they are added to or removed from our network. Additionally, we are making improvements to the process for tracking network assets not deployed in the network.

During the quarter ended September 30, 2002, we also recorded in network and product costs an additional charge of \$1,215 related to the capitalization of certain operating expenses in prior periods. To address this matter, we are adding additional internal processing controls to prevent the capitalization of these operating expenses.

We believe that these initiatives will adequately address these control matters and we do not anticipate additional material adjustments related to network assets in subsequent periods related to the above described items.

Except as noted above, there were not any significant changes in our internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings (all dollar amounts are presented in thousands)

On May 24, 2002, the United States Court of Appeals for the District of Columbia vacated the Federal Communications Commission's ("FCC") decision granting competitive local exchange carriers like us the ability to purchase line-shared services from the traditional telephone companies. It is unclear when and if the FCC will issue a new order concerning line-sharing. The FCC and the Company filed a Motion for Reconsideration and a request to stay vacature of the line sharing order with the Court of Appeals pending the FCC's review of the line sharing order. On September 4, 2002, the Court of Appeal denied the FCC's and our Motion for Reconsideration, but granted the request to stay vacature of the line sharing order until January 2, 2003. We therefore have the continued right to line sharing until at least January 2, 2003. We also believe that we have a continued right to line-sharing under our interconnection agreements with the traditional telephone companies, but those agreements do allow the traditional telephone companies to renegotiate their terms based on a change in law. If the traditional telephone companies invoke this change-in-law provision, or if the FCC does not issue a new order allowing us to purchase line-shared services, it is possible that the traditional telephone companies could either refuse to sell us such services or could substantially increase the cost of line-shared services, either of which would have a material adverse effect on our business and could even result in a liquidation or sale of our business. The court also remanded the list of unbundled network elements that had been developed by the FCC. The FCC is in the process of reviewing the list of unbundled network elements, which include the transmission facilities and telephone lines that we purchase from the traditional telephone

companies in order to provide our services to our customers. If the FCC removes any of our existing transmission facilities or telephone lines from the previous list of unbundled network elements, the traditional telephone companies could either increase the cost of obtaining such transmission facilities and telephone lines or deny us access entirely, which would adversely affect our business.

On December 13, 2001, the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court") entered an order confirming our pre-negotiated First Amended Plan of Reorganization, as modified on November 26, 2001 (the "Plan"). On December 20, 2001 (the "Effective Date"), the Plan was consummated and we emerged from bankruptcy. Under our Plan, we settled several claims against us. These claims include:

- The class action lawsuits filed in the United States District Court for the Northern District of California, provided that this settlement will not be final unless it is approved by that court. This settlement is described in more detail below.
- The lawsuits filed in the Superior Court of the State of California for the County of Santa Clara by six purchasers of the convertible notes that we issued in September 2000.
- Disputed claims made by former shareholders of Laser Link.net.
- Disputed claims made by GE Capital and its subsidiary, Heller Financial Group.

As of September 30, 2002, there were approximately \$10,959 in unresolved claims related to our Chapter 11 bankruptcy proceedings. As of September 30, 2002, we have recorded \$9,997 for these unresolved claims in our condensed consolidated balance sheet. However, it is reasonably possible that our unresolved Chapter 11 bankruptcy claims could ultimately be settled for amounts that differ from the amounts recorded in our condensed consolidated balance sheet.

Purchasers of our common stock and purchasers of the convertible notes we issued in September 2000 have filed complaints on behalf of themselves and alleged classes of stockholders and holders of convertible notes against us and certain of our present and former officers and directors. These complaints were filed in the United States District Court for the Northern District of California ("District Court") in the fourth quarter of 2000. The complaints have been consolidated and the lead plaintiff has filed its amended consolidated complaint. The amended consolidated complaint alleges violations of federal securities laws on behalf of persons who purchased or otherwise acquired our securities, including common stock and notes, during the period from April 19, 2000 to May 24, 2001. The relief sought includes monetary damages and equitable relief. We and the officer and director defendants entered into a memorandum of understanding ("MOU") with counsel for the lead plaintiffs in this litigation that tentatively resolves the litigation. The MOU sets forth the terms upon which we, the officer and director defendants and the plaintiffs agree to settle the litigation. Pursuant to the MOU, the plaintiffs agreed to support and vote in favor of our bankruptcy plan if it provided for the distribution of \$16,500 in cash to be funded by our insurance carriers and 6,495,844 shares of our common stock. The plaintiffs voted in favor of the Plan. The settlement provided for in the MOU is subject to the approval of the District Court, which preliminarily approved the settlement on October 29, 2002. The 6,495,844 shares issuable to the plaintiffs upon such approval by the District Court were issued on the Effective Date of the bankruptcy and are being held by us in escrow, pending approval by the District Court. We believe we have strong defenses to the claims alleged in the lawsuit and intend to contest the lawsuit vigorously if the District Court does not approve the final settlement. Because this action is at an early stage, however, we are unable to provide an evaluation of the ultimate outcome of the litigation if the court does not approve the final settlement agreement. Although we believe it is more likely than not that this settlement will be completed, we do not expect this process to be completed for several months.

In April 1999, we filed a lawsuit against Bell Atlantic (now Verizon) and its affiliates in the United States District Court for the District of Columbia. We are pursuing antitrust and other claims in this lawsuit arising out of Verizon's conduct as a supplier of network facilities, including central office space, transmission facilities and telephone lines. In December 2000, we also filed a lawsuit against BellSouth Telecommunications and its subsidiaries in the United States District Court for the Northern District of Georgia. We are pursuing claims in this lawsuit that are similar to our claims against Verizon. Both courts dismissed some of

our claims based on the ruling of the Seventh Circuit in *Goldwasser v. Ameritech*. The court in the Verizon case also dismissed our remaining claims on other grounds. We voluntarily dismissed our remaining claims in the BellSouth case so we could pursue certain issues on appeal. We have appealed these decisions to the United States Court of Appeals for the Eleventh Circuit and the United States Court of Appeals for the District of Columbia. On August 2, 2002, the Eleventh Circuit Court of Appeals reversed the lower court's decision in the BellSouth case and remanded the case for further proceedings. BellSouth has requested a rehearing before the Eleventh Circuit and that request is still pending. We cannot predict the outcome of these matters.

On June 11, 2001, Verizon Communications filed a lawsuit against us in the United States District Court for the Northern District of California. Verizon is a supplier of telephone lines that we use to provide services to our customers. It claims that we falsified trouble ticket reports with respect to the phone lines that we *ordered and made false statements to the public and governmental authorities critical of Verizon, and seeks unspecified monetary damages (characterized as being in the "millions") and injunctive relief.* The current complaint asserts causes of action for negligent and intentional misrepresentation and violations of California's unfair competition statute. We believe we have strong defenses to this lawsuit, but litigation is inherently unpredictable and there is no guarantee we will prevail.

Several stockholders have filed complaints in the United States District Court for the Southern District of New York, on behalf of themselves and purported classes of stockholders, against us and several former and current officers and directors in addition to some of the underwriters in our stock offerings. These lawsuits are so-called IPO allocation cases, challenging practices allegedly used by certain underwriters of public equity offerings during the late 1990s and 2000. On April 19, 2002 the plaintiffs amended their complaint and removed us as a defendant. Certain directors and officers are still named in the complaint. The plaintiffs claim that we failed to disclose the arrangements that some of these underwriters purportedly made with certain investors. We believe we have strong defenses to these lawsuits and we intend to contest them vigorously. However, because these lawsuits are at an early stage, we are unable to provide an evaluation of the ultimate outcome of the litigation.

A manufacturer of telecommunications hardware named "COVID" has filed an opposition to our trademark application for the mark "COVAD and design" and is seeking to cancel our registration of the COVAD trademark. We do not believe that this opposition has merit, but trademark proceedings are unpredictable and there is no guarantee we will prevail. If we do not succeed, it could limit our ability to provide our services under the "COVAD" name. In September 2000, COVID also filed a complaint in the United States District Court for the District of Arizona, *alleging claims for false designation of origin, infringement and unfair competition.* COVID is seeking an injunction to stop us from using the COVAD trademark, as well as an award of monetary damages. We do not believe that these claims have any merit, but the outcome of litigation is unpredictable and we cannot guarantee that we will prevail.

We are also a party to a variety of legal proceedings as either plaintiff or defendant, or are engaged in business disputes that arise in the ordinary course of business. Failure to resolve these various legal disputes and controversies without excessive delay and cost and in a manner that is favorable to us could significantly harm our business. We do not believe the ultimate outcome of these matters will have a material impact on our consolidated financial position and results of operations. However, litigation is inherently unpredictable and there is no guarantee we will prevail or otherwise not be adversely affected.

We are, subject to state commission, FCC and court decisions as they relate to the interpretation and implementation of the 1996 Telecommunications Act, the interpretation of competitive telecommunications company interconnection agreements in general, and our interconnection agreements in particular. In some cases, we may be deemed to be bound by or we may otherwise be significantly impacted by the results of ongoing proceedings of these bodies or the legal outcomes of other contested interconnection agreements that are similar to our agreements. The results of any of these proceedings could harm our business.

In addition, we are engaged in a variety of negotiations, arbitrations and regulatory and court proceedings with several traditional telephone companies. These negotiations, arbitrations and proceedings concern the traditional telephone companies' denial of physical central office space to us in certain central offices, the cost

and delivery of transmission facilities and telephone lines and central office spaces, billing issues and other operational issues. Other than the payment of legal fees and expenses, which are not quantifiable but are expected to be material, we do not believe that these matters will result in material liability to us and the potential gains are not quantifiable at this time. However, an unfavorable outcome in any of these negotiations, arbitrations and regulatory proceedings could have a material adverse effect on our consolidated financial position and results of operations if we are denied or charged higher rates for transmission lines or central office spaces.

Item 2. *Changes in Securities and Use of Proceeds*

On September 4, 2002, in conjunction with the execution of a five-year Broadband Internet Access Service Agreement (the "Broadband Agreement") with America Online, Inc. ("AOL"), a wholesale customer, we granted AOL three warrants to purchase an aggregate of 3,500,000 shares of the our common stock. We did not receive any additional purchase price for our issuance of the warrants. The first warrant is for 1.5 million shares at \$1.06 per share, the second warrant is for 1 million shares at \$3.00 per share and the third warrant is for 1 million shares at \$5.00 per share.

Such warrants were immediately exercisable, fully vested and non-forfeitable at the date of grant. The warrants were issued in a private placement under section 4(2) of the Securities Exchange Act of 1933.

Item 3. *Defaults upon Senior Securities*

None

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

On July 25, 2002, we held our Annual Meeting of Stockholders. Set forth below is a summary of each matter voted upon at the meeting and the number of votes cast for, against or withheld, as well as the number of abstentions and broker non-votes.

Proposal 1 — The election of three Class II directors to serve on our Board of Directors for a term to expire at the third succeeding annual meeting and until their successors are elected and qualified.

<u>Name</u>	<u>For</u>	<u>Withheld</u>
Charles E. Hoffman	191,919,970	6,433,748
Charles McMinn	192,859,746	5,493,972
Robert Hawk	191,221,803	7,131,915

Proposal 2 — Ratification of independent auditors, Ernst & Young LLP, for the 2002 fiscal year: 191,346,619 votes in favor, 6,726,753 votes against, and 280,347 votes abstained.

Item 5. *Other Information*

None

Item 6. *Exhibits and Reports on Form 8-K*

a. *Exhibits:*

<u>Exhibit Number</u>	<u>Description</u>
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b. *Reports on Form 8-K*

On July 2, 2002, the Company filed a current report on Form 8-K, pursuant to Item 5 thereof, reporting (i) that L. Dale Crandall joined the Company's Board of Directors and will serve on its audit committee and (ii) that Brad Sonnenberg was promoted to senior vice president and general counsel of the Company.

On July 26, 2002, the Company filed a current report on Form 8-K, pursuant to Item 5 thereof, reporting that Richard A. Jalkut joined the Company's Board of Directors.

On September 5, 2002, the Company filed a current report on Form 8-K, pursuant to Item 5 thereof, reporting that the Company signed a five year Broadband Internet Access Services Agreement with America Online, Inc.

On September 23, 2002, the Company filed a current report on Form 8-K, pursuant to Item 5 thereof, reporting that the Company signed a three year Broadband Internet Access Services Agreement with AT&T Corp.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

COVAD COMMUNICATIONS GROUP, INC.

By: /s/ CHARLES E. HOFFMAN
 Charles E. Hoffman
 President, Chief Executive Officer and Director

Date: November 7, 2002

By: /s/ MARK RICHMAN
 Mark Richman
 *Executive Vice President and
 Chief Financial Officer*

Date: November 7, 2002

CERTIFICATIONS

I, Charles E. Hoffman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Covad Communications Group, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

COVAD COMMUNICATIONS GROUP, INC.

By: /s/ CHARLES E. HOFFMAN
Charles E. Hoffman
President, Chief Executive Officer and Director

Date: November 7, 2002

I, Mark Richman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Covad Communications Group, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

COVAD COMMUNICATIONS GROUP, INC.

By: /s/ MARK RICHMAN
Mark Richman
*Executive Vice President and
Chief Financial Officer*

Date: November 7, 2002

<u>Exhibit Number</u>	<u>Description</u>
99.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

COVAD Communications Company

Exhibit V

Litigation Review

**CLAIMS INVOLVING TELECOMMUNICATIONS CARRIERS AND
COVAD COMMUNICATIONS GROUP, INC. AND ITS SUBSIDIARIES**

Complainant	Matter	Description	Date Asserted	Status
Verizon Delaware Inc., Verizon New England, Inc., Verizon New York, Inc., Verizon Maryland, Inc., Verizon Pennsylvania, Inc., Verizon Washington D.C., Inc., Verizon New Jersey, Inc.	Verizon Delaware, Inc. et al. v. Covad Communications Company, USDC Northern District of California, CA No. C 01-20524	Complaint alleging negligent and intentional misrepresentation related to alleged falsification of trouble tickets	6/11/2001	Judgment in favor of Covad; Motion for Reconsideration Pending
Covad Communications Company and DIECA	BellSouth USDC Northern District Georgia Case No. 1:00 CV 3414	Complaint against BellSouth for antitrust violations	12/22/00	Pending
Covad Communications Company and DIECA	Bell Atlantic USDC District of Columbia 99 CV 01046	Complaint against Bell Atlantic for antitrust violations	4/28/99	Pending

COVAD Communications Company

Exhibit VI

Tariff

TITLE PAGE
FLORIDA TELECOMMUNICATIONS TARIFF
OF
DIECA Communications, Inc. d/b/a COVAD Communications Company

This tariff contains the descriptions, regulations, and rates applicable to the furnishing of resold telecommunication services provided by DIECA Communications, Inc. d/b/a COVAD Communications Company ("Covad") with principal offices located at 3420 Central Expressway, Santa Clara, CA 95051. This tariff applies to services furnished within the State of Florida. This tariff is on file with the Florida Public Service Commission, and copies may be inspected, during normal business hours, at the Company's principal place of business.

Issued: February 10, 2003

By: Gene Watkins, Senior Counsel
1230 Peachtree St. NE, 19th Floor
Atlanta, Georgia 30309

Effective:

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CHECK SHEET

Pages of this tariff, as indicated below, are effective as of the date shown at the bottom of the respective pages. Original and revised pages, as named below, comprise all changes from the original tariff and are currently in effect as of the date on the bottom of this page.

PAGE	REVISION		PAGE	REVISION	
1	Original	*	26	Original	*
2	Original	*	27	Original	*
3	Original	*	28	Original	*
4	Original	*	29	Original	*
5	Original	*			
6	Original	*			
7	Original	*			
8	Original	*			
9	Original	*			
10	Original	*			
11	Original	*			
12	Original	*			
13	Original	*			
14	Original	*			
15	Original	*			
16	Original	*			
17	Original	*			
18	Original	*			
19	Original	*			
20	Original	*			
21	Original	*			
22	Original	*			
23	Original	*			
24	Original	*			
25	Original	*			

* - indicates those pages included with this filing

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Gene Watkins, Senior Counsel
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SYMBOLS

The following are the only symbols used for the purposes indicated below:

- (D) - Delete or Discontinue
- (I) - Change Resulting in an Increase to a Customer's Bill
- (M) - Moved from another Tariff Location
- (N) - New
- (R) - Change Resulting in a Reduction to a Customer's Bill
- (T) - Change in Text or Regulation but no Change in Rate or Charge.

When changes are made in any tariff sheet, a revised sheet will be issued canceling the tariff sheet affected. Changes will be identified on the revised sheet(s) through the use of the above-mentioned symbols.

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TARIFF FORMAT

- A. Page Numbering** - Page numbers appear in the upper right corner of the page. Pages are numbered sequentially. However, new pages are occasionally added to the tariff. When a new page is added between pages already in effect, a decimal is added. For example, a new sheet added between pages 14 and 15 would be 14.1.
- B. Page Revision Numbers** - Revision numbers also appear in the upper right corner of each page. These numbers are used to determine the most current page version on file with the FPSC. For example, the 4th Revised Page 14 cancels the 3rd Revised Page 14. Because of various suspension periods, deferrals, etc. the FPSC follows in their tariff approval process, the most current page number on file with the Commission is not always the tariff page in effect. Consult the check sheet for sheet currently in effect.
- C. Paragraph Numbering Sequence** - There are nine levels of paragraph coding. Each level of coding is subservient to its next higher level:
- 2.
 - 2.1.
 - 2.1.1.
 - 2.1.1.A.
 - 2.1.1.A.1.
 - 2.1.1.A.1.(a).
 - 2.1.1.A.1.(a).I.
- D. Check Sheets** - When a tariff filing is made with the FPSC, an updated check sheet accompanies the tariff filing. The check sheet lists the pages contained in the tariff, with a cross reference to the current revision number. When new pages are added, the check sheet is changed to reflect the revision. All revisions made in a given filing are designated by an asterisk (*). There will be no other symbols used on the check sheet if these are the only changes made to it (i.e., the format, etc. remains the same, just revised revision levels on some pages). The tariff user should refer to the latest check sheet to find out if a particular page is the most current on file with the FPSC.

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SECTION 1 - TERMS AND ABBREVIATIONS

Accounting Code - A numerical code that enables Customer to allocate charges to its internal accounts.

Access Line - An arrangement from a local exchange telephone company or other common carrier, using either dedicated or switched access that connects Customer's location to Company's location or switching center.

Authorization Code - A numerical code, one or more of which the Company may assign to Customer, to enable Company to identify the origin of service of the Customer so it may rate and bill the call. All Authorization Codes shall be the sole property of Company and no Customer shall have any property or other right or interest in the use of any particular Authorization Code. Automatic numbering identification (ANI) may be used as or in connection with the Authorization Code.

Authorized User - A person, firm, partnership, corporation or other entity who is authorized by the Customer to be connected to and utilize the Carrier's services under the terms and regulations of this tariff.

Automatic Number Identification (ANI) - A type of signaling provided by a local exchange telephone company, which automatically identifies the local exchange line from which a call originates.

Commission - Refers to the Florida Public Service Commission.

Company or Carrier - DIECA Communications, Inc. d/b/a COVAD Communications Company, issuer of this tariff.

Covad- Refers to DIECA Communications, Inc. d/b/a COVAD Communications Company, issuer of this tariff.

Customer - A person, firm, partnership, corporation or other entity which arranges for the Carrier to provide, discontinue or rearrange telecommunications services on behalf of itself or others; uses the Carrier's telecommunications services; and is responsible for payment of charges, all under the provisions and terms of this tariff.

Dedicated - A facility or equipment system or subsystem set aside for the sole use of a specific customer.

End User - Any person, firm, corporation, partnership or other entity which uses the services of the Company under the provisions and regulations of this tariff. The End User is responsible for payment unless the charges for the services utilized are accepted and paid by another Customer.

FPSC - Florida Public Service Commission.

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SECTION 1 - TERMS AND ABBREVIATIONS, (CONT'D.)

LATA - Local Area of Transport and Access.

LEC - Local Exchange Company.

PIC/Primary Interexchange Carrier - Interexchange carrier designated by Customer to provide interexchange services without need to dial special access code.

Service Commencement Date - The first day following the date on which the Company notifies the Customer that the requested service or facility is available for use.

Service Order - The request for services, either written or electronic, executed by the Customer and the Company in the format devised by the Company. Such request for services by the Customer and acceptance by the Company initiates the respective obligations of the parties as set forth therein and pursuant to tariff, but the duration of the service is calculated from the Service Commencement Date.

Switched Access Origination/Termination - Where access between the Customer and the interexchange carrier is provided on local exchange company Feature Group circuits and the connection to the Customer is a LEC-provided business or residential access line. The cost of switched Feature Group access is billed to the interexchange carrier.

Timely Payment - A payment on Customer's account made on or before the due date.

Term Agreement: An agreement between the Company and the Customer for a fixed term of months.

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Atlanta, Georgia 30309

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SECTION 2 - RULES AND REGULATIONS**2.1 Undertaking of DIECA Communications, Inc. d/b/a COVAD Communications Company**

The Company provides long distance message telecommunications service to Customers for their direct transmission of voice, data and other types of telecommunications.

Communications originate when the Customer accesses the Company directly or through the facilities of another carrier via one or more access lines, equal access or on a dial-up basis. The Company may act as the Customer's agent for ordering access connection facilities provided by other carriers or entities when authorized by the Customer, to allow connection of a Customer's location to the Company's network. The Customer shall be responsible for all charges due for such service arrangements.

The Company's services are provided on a monthly basis, unless otherwise stated in this tariff. Services are available twenty-four (24) hours per day, seven (7) days per week.

2.2 Use

- 2.2.1** Service may be used for any lawful purpose for which it is technically suited. Customers reselling or rebilling the Company's Florida intrastate service must have a Certificate of Public Convenience and Necessity as an interexchange carrier from the Florida Public Service Commission.
- 2.2.2** Services provided under this tariff may be used by the Customer for any lawful telecommunications purpose for which the service is technically suited.
- 2.2.3** The services the Company offers shall not be used for any unlawful purpose or for any use as to which the Customer has not obtained all required governmental approvals, authorizations, licenses, consents and permits.
- 2.2.4** The Company may require applicants for service who intend to use the Company's offerings for resale, shared and/or joint use to file a letter with the Company confirming that their use of the Company's offerings complies with relevant laws and the Commission's regulations, policies, orders, and decisions.
- 2.2.5** A Customer may transmit or receive information or signals via the facilities of the Company. The Company's services are designed primarily for the transmission of voice-grade telephonic signals, except as otherwise stated in this tariff. A user may transmit any form of signal that is compatible with the Company's equipment, but the Company does not guarantee that its services will be suitable for purposes other than voice-grade telephonic communication except as specifically stated in this tariff.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.3 Limitations

- 2.3.1 The Company reserves the right to discontinue service when necessitated by conditions beyond its control, or when the Customer is using the service in violation of the provisions of this tariff, or in violation of the law.
- 2.3.2 Service is offered subject to the availability of the necessary facilities and equipment, or both facilities and equipment, and subject to the provisions of this tariff.
- 2.3.3 The Company does not undertake to transmit messages, but offers the use of its facilities when available, and will not be liable for errors in transmission or for failure to establish connections.
- 2.3.4 Service may be limited or discontinued by the Company, without notice to the Customer, by blocking traffic to certain countries, cities, or NXX exchanges when the Company deems it necessary to take such action to prevent unlawful use of its service. Service will be restored as soon as it can be provided without undue risk.
- 2.3.5 The Company reserves the right to limit or to allocate the use of existing facilities, or of additional facilities offered by the Company, when necessary because of lack of facilities, or due to some other cause beyond the Company's control.
- 2.3.6 To the extent that any conflict arises between the terms and conditions of a service agreement or other contract and the terms and conditions of this tariff, the tariff shall prevail.
- 2.3.7 Title to all equipment provided by the Company under this tariff remains with the Company.

Issued: February 10, 2003

Effective:

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.4 Assignment and Transfer

- 2.4.1** All facilities provided under this tariff are directly or indirectly controlled by Covad and neither the Customer nor Subscriber may transfer or assign the use of service or facilities without the express written consent of the Company. All regulations and conditions contained in this tariff shall apply to all such permitted assignees or transferees, as well as all conditions of service. Such transfer or assignment, when permitted, shall only apply where there is no interruption of the use or location of the service or facilities.
- 2.4.2** Customer may request Carrier to assign one or more sub-accounts for billing purposes, and to direct sub-account invoices to Customer's affiliates or other designated entities for payment. Such requests shall not affect the liability of the Customer, who shall remain solely liable to the Company for payment of all invoices for service requested and obtained by Customer, whether invoiced by the Company to the Customer, the Customer's affiliates, or other designated entities.

Issued: February 10, 2003

Effective:

By: Gene Watkins, Senior Counsel
1230 Peachtree St. NE, 19th Floor
Atlanta, Georgia 30309

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)**2.5 Liability of the Company**

- 2.5.1** Covad's liability for damages arising out of mistakes, interruptions, omissions, delays, errors, or defects in transmission which occur in the course of furnishing service or facilities, in no event shall exceed \$100.00 or an amount equivalent to the proportionate charge to the Customer, whichever is less, for the period during which the faults in transmission occur. Except as set forth above, the Company shall not be liable for any direct, indirect, consequential, special, actual, punitive or any other damages, or business interruption, or for any lost profits of any kind or nature whatsoever arising out of any defects or any other cause. In the event of an interruption in service or any defect in the service whatsoever, neither the Company nor any affiliated or unaffiliated third party provider or operator of facilities employed in the provision of the service shall be liable for any direct, indirect, consequential, special, actual, punitive or any other damages, or for any lost profits of any kind or nature whatsoever. Moreover, any such mistakes, omissions, interruptions, delays, errors, or defects in transmission or service, which are caused or contributed to by the negligence or willful act of the Customer, or Authorized User, or joint user, or which arise from the use of Customer provided facilities or equipment shall not result in the imposition of any liability whatsoever upon the Company.
- 2.5.2** The Company shall not be liable for any claim or loss, expense or damage (including indirect, special or consequential damage), for any interruption, delay, error, omission, or defect in any service, facility or transmission provided under this tariff, if caused by any person or entity other than the Company, by any malfunction of any service or facility provided by any other carrier, by an Act of God, fire, war, civil disturbance, or act of government, or by any other cause beyond the Company's direct control.
- 2.5.3** Indemnification - The Company's liability, if any, for its gross negligence or willful misconduct is not limited by this tariff. With respect to any other claim or suit by a Customer or by any others, the Customer indemnifies and saves harmless the Company against claims, losses or suits for injury to or death of any person, or damage to any property which arises from the use, placement or presence of the Company's equipment, facilities and associated wiring of the Customer's premises and further the Customer indemnifies and saves harmless the Company against claims for libel, slander, invasion of privacy or the infringement of copyright arising directly or indirectly from the material transmitted over the facilities of the Company or the use thereof by the Customer; against claims for infringement of patents arising from combining with or using in connection with, facilities furnished by the Company and apparatus, equipment and systems provided by the Customer; and against all other claims arising out of any act or omission of the Customer in connection with the services or facilities provided by the Company. No agents or employees of other carriers shall be deemed to be agents or employees of the Company.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.5 Liability of the Company, (Cont'd.)

- 2.5.4** Defacement of premises: No liability shall attach to the Company by reason of any defacement or damage to the Customer's premises resulting from the existence of the Company's equipment or facilities on such premises, or by the installation or removal thereof, when such defacement or damage is not the result of the negligence of the Company or its employees.
- 2.5.5** The Company is not liable for any act or omission of any other entity furnishing a portion of the service or any acts or omission of the Customer.
- 2.5.6** Service furnished by the Company may be interconnected with the services or facilities of other carriers or private systems. However, service furnished is provided solely by the Company and is not a joint undertaking with other parties.
- 2.5.7** The Company shall not be liable for any claim, loss, or refund as a result of loss or theft of Personal Identification Numbers issued for use with the Company's services.
- 2.5.8** The Company shall not be liable for any damages, including usage charges, that the Customer may incur as a result of the unauthorized use of authorization codes of communications equipment. The unauthorized use of communications equipment includes, but is not limited to, the placement of calls from the Customer's premises, and the placement of calls through equipment controlled and/or provided by the Customer that are transmitted over the company's network without the authorization of the Customer. The Customer shall be fully liable for all such usage charges.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)**2.6 Customer Responsibility**

2.6.1 All Customers assume general responsibilities in connection with the provisions and use of the Company's service. When facilities, equipment, and/or communication systems provided by others are connected to the Company's facilities, the Customer assumes additional responsibilities. All Customers are responsible for the following:

- A.** The Customer is responsible for placing orders for service, paying all charges for service rendered by the Company and complying with all of the Company's regulations governing the service. The Customer is also responsible for assuring that its users comply with regulations.
- B.** When placing an order for service, the Customer must provide:
 - 1. The names and addresses of the persons responsible for the payment of service charges, and
 - 2. The names, telephone numbers, and addresses of the Customer contact persons.
- C.** The Customer must pay the Company for the replacement or repair of the Company's equipment when the damage results from:
 - 1. The negligence or willful act of the Customer or user;
 - 2. Improper use of service; and
 - 3. Any use of equipment or service provided by others.
- D.** After receipt of payment for the damages, the Company will cooperate with the Customer in prosecuting a claim against any third party causing damage.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.6 Customer Responsibility, (Cont'd.)

2.6.2 Billing and Payment For Service

A. Responsibility for Charges

The Customer is responsible for payment of all charges for services and equipment furnished to the Customer for transmission of calls via the Company. In particular and without limitation to the foregoing, the Customer is responsible for any and all cost(s) incurred as the result of:

- .1 any delegation of authority resulting in the use of his or her communications equipment and/or network services which result in the placement of calls via the Company;
- .2 any and all use of the services provided by the Company, including calls which the Customer did not individually authorize;
- .3 any calls placed by or through the Customer's equipment via any remote access feature(s);

Charges for installations, service connections, moves and rearrangements are payable upon demand to the Company or its authorized agent. Billing thereafter will include recurring charges and actual usage as defined in this tariff.

B. Disputed Charges

Any objections to billed charges must be reported to the Company or its billing agent in writing within twenty (20) days of the closing date printed on the invoice or statement issued to the Customer. Adjustments to Customers' account shall be made to the extent that circumstances exist which reasonably indicate that such changes are appropriate.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.6 Customer Responsibility, (Cont'd.)

2.6.3 Taxes and Fees

- A.** All state and local taxes (e.g., gross receipts tax, sales tax, municipal utilities tax) are not included in the rates under this tariff, but shall be listed as separate line items on the Customer's bill.
- B.** To the extent that a municipality, other political subdivision or local agency of government, or commission imposes and collects from the Company a gross receipts tax, occupation tax, license tax, permit fee, franchise fee, or regulatory fee, such taxes and fees shall, as allowed by law, be billed pro rata to the Customer receiving service from the Company within the territorial limits of such municipality, other political subdivision or local agency of government.
- C.** Service shall not be subject to taxes for a given taxing jurisdiction if the Customer provides the Company with written verification, acceptable to the Company and to the relevant taxing jurisdiction, that the Customer has been granted a tax exemption.
- D.** The Company may adjust its rates or impose additional rates on its Customer to recover amounts it is required by governmental or quasi-governmental authorities to collect from or pay to others. The Company may also adjust its rates or impose additional rates to cover the administrative cost of collecting such charges or paying compensation to other entities. Examples of such programs include, but are not limited to, the Universal Service Fund (USF), and compensation to pay telephone service providers for the use of their pay telephones to access the Company's services.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.6 Customer Responsibility, (Cont'd.)

2.6.4 Late Payment Fees

A late payment fee of 1.5% per month will be charged on any past due balance. Any applicable late payment fees will be assessed according to the terms and conditions of the Company or its billing agent and pursuant to Florida state law.

2.6.5 Return Check Charge

A Return Check Charge of \$25.00 will be assessed for checks returned for insufficient funds if the face value does not exceed \$50, \$30 if the face value does exceed \$50 but does not exceed \$300, \$40 if the face value exceeds \$300 or 5% of the value of the check, whichever is greater.

2.6.6 Deposits

The Company does not collect Customer deposits.

2.6.7 Advance Payments

The Company does not require advance payments for service.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)**2.7 Refunds or Credits for Service Outages or Interruptions**

- 2.7.1** An interruption period begins when the Customer reports a service, facility or circuit to be inoperative and, if necessary, releases it for testing and repair. An interruption period ends when the service, facility or circuit is operative. Credits for service outages or interruptions are subject to the regulations listed below.
- 2.7.2** If the Customer reports a service, facility or circuit to be interrupted but declines to release it for testing and repair, or refuses access to its premises for test and repair by the Company, the service, facility or circuit is considered to be impaired but not interrupted. No credit allowances will be made for a service, facility or circuit considered by the Company to be impaired.
- 2.7.3** Credit allowances for interruption periods which are not due to the Company's testing or adjusting, to the negligence of the Customer, or to the failure of channels, equipment and/or communications systems provided by the Customer, are subject to the general liability provisions set forth in this tariff. It shall be the obligation of the Customer to notify Company immediately of any interruption in service for which a credit allowance is desired by Customer. Before giving such notice, the Customer shall ascertain that the trouble is not within his or her control, or is not in wiring or equipment, if any, furnished by Customer.
- 2.7.4** The Customer shall be responsible for the payment of service charges based upon time and materials for visits by the Company's agents or employees to the premises of the Customer when the service difficulty or trouble report results from the use of equipment or facilities provided by any party other than the Company, including but not limited to the Customer.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)**2.7 Refunds or Credits for Service Outages or Interruptions, (Cont'd.)**

2.7.5 For purposes of credit computation every month shall be considered to have seven hundred and twenty (720) hours. For services with a monthly recurring charge, no credit shall be allowed for an interruption of continuous duration of less than four (4) hours. The Customer shall be credited for an interruption of four (4) or more hours at the rate of 1/720th of the monthly charge for the services affected for each hour that the interruption continues. The formula used for computation of credits is as follows:

$$\text{Credit} = A/720 \times B$$

A = outage time in hours (must be 4 or more)

B = total monthly recurring charge for affected service.

2.7.6 For usage sensitive long distance services, credits will be limited to, a maximum, the price of the Initial Period of the individual call that was interrupted plus any per call charges or surcharges required to reconnect the caller.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.8 Cancellation or Termination of Service by Customer

2.8.1 Customers of presubscribed long distance services may cancel service at any time by providing Covad with written or verbal notification. The Company shall hold the Customer responsible for payment of all bills for service furnished until the cancellation date specified by the Customer or until the date that the cancellation notice is received, whichever is later.

2.9 Cancellation or Termination of Service by Company

2.9.1 For nonpayment: The Company may terminate service to a Customer or Subscriber for nonpayment of undisputed charges upon five (5) working days written notice to the Customer or Subscriber without incurring any liability for damages due to loss of telephone service to the Customer or Subscriber.

2.9.2 Covad may refuse or discontinue service under the following conditions provided that, unless otherwise stated, the Customer shall be given five (5) days notice to comply with any rule or remedy any deficiency:

- A.** For non-compliance with or violation of any State, Municipal, or Federal law, ordinance or regulation pertaining to telephone service.
- B.** For use of telephone service for any purpose other than that described in the application.
- C.** For neglect or refusal to provide reasonable access to Covad or its agents for the purpose of inspection and maintenance of equipment owned by Covad or its agents.
- D.** With five (5) working days written notice for noncompliance with or violation of Commission regulation or Covad's rules and regulations on file with the Commission.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.9 Cancellation or Termination of Service by Company, (Cont'd.)

2.9.2 Continued

- E.** Without notice in the event of Customer, Subscriber or Authorized User use of equipment in such a manner as to adversely affect Covad's equipment or service to others.
- F.** Without notice in the event of tampering with the equipment or services owned by Covad or its agents.
- G.** Without notice in the event of unauthorized or fraudulent use of service. Whenever service is discontinued for fraudulent use of service, Covad may, before restoring service, require the Customer or Subscriber to make, at his or her own expense, all changes in facilities or equipment necessary to eliminate illegal use and to pay an amount reasonably estimated as the loss in revenues resulting from such fraudulent use.
- H.** Without notice by reason of any order or decision of a court or other government authority having jurisdiction which prohibits Company from furnishing such services.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)**2.10 Interconnection**

Service furnished by Covad may be connected with the services or facilities of other carriers. Such service or facilities are provided under the terms, rates and conditions of the other carrier. The Customer is responsible for all charges billed by other carriers for use in connection with Covad's service. Any special interface equipment or facilities necessary to achieve compatibility between carriers is the responsibility of the Customer.

2.11 Terminal Equipment

The Company's facilities and service may be used with or terminated in terminal equipment or communications systems such as a PBX, key system, single line telephone, or pay telephone. Such terminal equipment shall be furnished and maintained at the expense of the Customer. The Customer is responsible for all costs at his or her premises, including personnel, wiring, electrical power, and the like, incurred in the use of Covad's service. When such terminal equipment is used, the equipment shall comply with the generally accepted minimum protective criteria standards of the telecommunications industry.

2.12 Inspection, Testing and Adjustment

Upon reasonable notice, the facilities or equipment provided by the Company shall be made available to the Company for such tests and adjustments as may be necessary for their maintenance in a condition satisfactory to the Company. No interruption allowance shall be granted for the time during which such tests and adjustments are made, unless such interruption exceeds twenty-four (24) hours in length and credit for the interruption is requested by the Customer.

2.13 900, 976 and 700 Numbers

The Company does not provide 900, 976 or 700 number services. Customer calls placed to these numbers are routed to the local or long distance carrier providing the service. Customers may contact their local exchange carrier or the carrier providing the service to request blocking of access to these numbers.

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SECTION 2 - RULES AND REGULATIONS, (CONT'D.)

2.14 Toll Free Services

2.14.1 The Company will make every effort to reserve toll free (i.e., "800/888") vanity numbers for Customers, but makes no guarantee or warranty that the requested number(s) will be available.

2.14.2 Toll free numbers shared by more than one Customer, whereby individual Customers are identified by a unique Personal Identification Number, may not be assigned or transferred for use with service provided by another carrier. Subject to the limitations provided in this tariff, the Company will only honor Customer requests for a change in Responsible Organization or toll free service provider for toll free numbers dedicated to the sole use of that single Customer.

2.14.3 If a Customer who has received a toll free number does not subscribe to toll free service within thirty (30) days, the Company reserves the right to make the assigned number available for use by another Customer.

2.15 Other Rules

The Company may temporarily suspend service without notice to the Customer, by blocking traffic to certain cities of NXX exchanges, or by blocking calls using certain Personal Identification Numbers when the Company deems it necessary to take such action to prevent unlawful use of its service. The Company will restore service as soon as service can be provided without undue risk.

2.16 Applicable Law

This tariff shall be subject to and construed in accordance with Florida law.

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SECTION 3 - SERVICE DESCRIPTIONS

3.1 General

Service is offered for interexchange calling to business Customers pursuant to the terms of this tariff.

Service is available 24 hours per day, 7 days per week, and is subject to the availability of necessary equipment and facilities and the economic feasibility of providing such necessary equipment and facilities.

Services are offered via the Company's facilities (whether owned, leased or under contract) where available in combination with resold services provided by other certificated carriers.

Service will be provided subject to the availability and limitations of the wire centers and outside plant facilities and is only available where technical capabilities permit. The actual data transmission rate, and therefore, a circuit's ability to accommodate multiple voice lines, depends on a number of factors, including, but not limited to (1) the copper facility (wire gauge) and (3) the physical plant. Additionally, unlike many conventional telecommunications technologies, DSL requires that suitable electrical power be supplied at the customer's premises for the service to be functional. Company is not responsible for service outage credits and other liabilities of any nature due to electrical power failure at the Customer's location(s).

3.2 Quality and Grade of Service Offered

Minimum Call Completion Rate - Customers can expect a call completion rate of not less than 90% during peak use periods. The call completion rate is calculated as the number of calls completed (including calls completed to a busy line or to a line which remains unanswered by the called party) divided by the number of calls attempted.

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SECTION 3 - SERVICE DESCRIPTIONS, (CONT'D.)

3.3 Timing of Calls

Billing for calls placed over the Covad network is based in part on the duration of the call as follows, unless otherwise specified in this tariff:

- 3.3.1 Timing of each call begins when the called station is answered (i.e. when two way communications are established). Answer detection is based on standard industry answer detection methods, including hardware and software answer detection.
- 3.3.2 Chargeable time for calls ends when one of the parties disconnects from the call.
- 3.3.3 The initial and additional billing increments are stated in the description of each service.
- 3.3.4 The Company will not knowingly bill for unanswered calls. When a Customer indicates that he/she was billed for an incomplete call, Covad will reasonably issue credit for the call.

3.4 Rate Periods

The Company does not offer time-of-day discounts.

3.5 Calculation of Distance

The Company does not offer mileage-sensitive services.

3.6 Holidays

The Company does not offer Holiday discounts.

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SECTION 3 - SERVICE DESCRIPTIONS, (CONT'D.)**3.7 Long Distance Service - Basic**

Long Distance Service - Basic ("LDS") is available to Customers of the Company's local exchange service and provides the ability to originate direct dialed calls over switched access lines to called locations outside of the Customer's Local Calling Area, but within the State of Florida. Calls are billed in one (1) minute increments with an initial billing period of one (1) minute. Service is available only on a term basis, with terms of one (1) or two (2) years to run concurrently with the terms for the Company's local exchange service.

3.8 Long Distance Service Calling Plans

Long Distance Service ("LDS") Calling Plans provide Customers subscribing to Company's LDS a discount against their per minute rate for defined minimum usage levels.

LDS Calling Plans are available with Covad's local service offerings, namely Integrated Voice Services 1 and Integrated Voice Services 2 local calling plans.

Integrated Voice Services 1: Includes a call allowance of 1,500 minutes of use for intraLATA and interLATA toll calls combined.

Integrated Voice Services 2: Includes a call allowance of 3,000 minutes of use for intraLATA and interLATA toll calls combined.

The following Plans are available to obtain additional minutes over the basic call allowance for Customers of either Voice Services Plan.

Plus 2,000 Plan provides an additional call allowance of 2,000 minutes of combined intraLATA and interLATA toll calls for a flat rate per month.

Plus 5,000 Plan provides an additional call allowance of 5,000 minutes of combined intraLATA and interLATA toll calls for a flat rate per month.

Calls above the call allowance are billed at the Long Distance Service - Basic rate per minute.

Any unused portion of the usage allowances will not carry forward to the following month. Usage in excess of call allowances will be billed at the standard rate for Long Distance Service - Basic.

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SECTION 3 - SERVICE DESCRIPTIONS, (CONT'D.)

3.9 Directory Assistance

Directory Assistance is available to Customers for all non-debit card services listed above. Directory Assistance charges applies to each call to the Directory Assistance Bureau. Up to two requests may be made on each call to Directory Assistance. The Directory Assistance charge applies to each call regardless of whether the Directory Assistance Bureau is able to furnish the requested telephone number.

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SECTION 4 - RATES

4.1 General

Each Customer is charged individually for each call placed through the Company. Duration of each call is measured as described in Section 3.3 of this tariff.

Services rates may vary by product, call type, mileage, time of day and day of week. Usage charges apply to all calls and are based on the duration of the call.

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SECTION 4 - RATES, (CONT'D.)

4.2 Long Distance Service - Basic

Rate per minute: \$0.07

4.3 Long Distance Service Calling Plans

Plan Name	Additional Minutes over Basic Allowance	Monthly Rate
Plus 2,000 Plan	2,000	\$100.00
Plus 3,000 Plan	3,000	\$200.00

4.4 Directory Assistance

Up to two requests may be made on each call to Directory Assistance.

Rate Per Call: \$0.75

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SECTION 4 - RATES, (CONT'D)

4.5 Special Rates for Presubscribed Handicapped Individuals

4.5.1 Directory Assistance

There shall be no charge for up to fifty calls per billing cycle from lines or trunks serving individuals with disabilities. The Company shall charge the prevailing tariff rates for every call in excess of 50 within a billing cycle.

4.5.2 Hearing and Speech Impaired Persons

Intrastate toll message rates for TDD users shall be evening rates for daytime calls and night rates for evening and night calls.

4.5.3 Telecommunications Relay Service

For intrastate toll calls received from the relay service, the Company will when billing relay calls discount relay service calls by 50 percent off of the otherwise applicable rate for a voice nonrelay call except that where either the calling or called party indicates that either party is both hearing and visually impaired, the calls shall be discounted 60 percent off of the otherwise applicable rate for a voice nonrelay call. The above discounts apply only to time-sensitive elements of a charge for a call and shall not apply to per call charges such as a credit card surcharge.

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